

Annual Report to Congress

National Taxpayer Advocate

2007 Annual Report to Congress

**NATIONAL
TAXPAYER
ADVOCATE**

2007 ANNUAL REPORT
TO CONGRESS

Volume Two

TAXPAYER ADVOCATE SERVICE
RESEARCH STUDIES AND REPORTS

2007

Report to Congress



YOUR VOICE AT THE IRS

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Preface

Over the years, I have stressed the importance of research to achieving effective tax administration. Accordingly, the Office of the Taxpayer Advocate has committed significant resources to studying issues that impact taxpayer compliance. Volume 2 of the 2007 National Taxpayer Advocate Annual Report to Congress reports on six of these studies.

In selecting research initiatives, the National Taxpayer Advocate and the Taxpayer Advocate Service (TAS) Office of Research seek answers to questions or empirical confirmation of assumptions that have significant import to tax administration. Moreover, because the National Taxpayer Advocate and the IRS may have different research priorities or different approaches to the same problem, we do not duplicate research the IRS is already conducting. No TAS research project, however, could be accomplished without the assistance of the IRS National Office and Operating Division Research staffs. I am extremely grateful for their insights, support, and cooperation.

This year, our research studies fall into two categories: first, a comprehensive strategy to address cash economy noncompliance; and second, an attempt to better understand what drives taxpayer compliance. In the first instance, I must admit some frustration with the perceived wisdom that it is almost impossible (and certainly too costly) to positively impact the cash economy tax gap.¹ This study is our response to that assumption. In it we set forth specific measures that we believe should be implemented immediately or warrant further study, all of which are promising in their ability to significantly improve tax compliance in the cash economy. We submit them to engender discussion and, most importantly, action.

The studies in the second category are quite diverse but have one thing in common – they all attempt to shed light on why taxpayers comply with the tax laws and what helps them comply. From our study of Earned Income Tax Credit (EITC) audit barriers and the impact of representation on the outcome of EITC exams, to a computer simulation of EITC filing behavior in the Hartford, Connecticut certification initiative, to our study of the impact of recently enacted Offer in Compromise payment rules on the ability of taxpayers to file successful offers – each of these studies looks at the burdens, barriers, and influences on taxpayers in filing, payment or compliance initiatives, and seeks to identify practices that would mitigate if not eliminate the burdens and barriers.

TAS commissioned two other studies in this second category from two highly respected academics – Professors Leslie Book and Marjorie Kornhauser. These studies include surveys of existing research and scholarship and provide insightful observations on two important

¹ Although there is no universally agreed-upon definition of “cash economy,” we use the term to mean taxable income from legal activities that is not reported to the IRS by third parties. This definition can include businesses dealing strictly in cash as well as others that handle a portion of their transactions in cash or receive other payments not subject to information reporting. For example, a retailer who receives most of his revenue through debit and credit cards can be considered part of the cash economy because these forms of payment are not subject to information reporting.

issues: the role of tax preparers and practitioners in tax compliance, and what factors motivate taxpayers to comply with the tax laws.

I believe all of these studies will serve as a baseline for future research, both within and outside of the IRS. They certainly inspire one to question and explore, even as we go about our day-to-day tasks in tax administration. For without that inquisitive spirit, and the willingness to follow where it leads, tax administration will lag behind the world in which it operates. If anything, what this volume demonstrates is how much you can learn if only you ask.



Nina E. Olson
National Taxpayer Advocate
31 December 2007

Annual Report to Congress

National Taxpayer Advocate

2007 Annual Report to Congress

A COMPREHENSIVE STRATEGY
FOR ADDRESSING
THE CASH ECONOMY

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2007

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A Comprehensive Strategy for Addressing the Cash Economy

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Cash Economy Strategy

Executive Summary

The IRS estimates that the gross tax gap – the difference between what taxpayers owe and what they pay voluntarily and timely – amounted to \$345 billion in tax year 2001.¹ Underreported income from the “cash economy” – income from legal activities that is not subject to information reporting or withholding – is probably the single largest component of the tax gap, likely accounting for over \$100 billion per year.²

The National Taxpayer Advocate believes the cash economy deserves special attention because of its size and the likelihood that it will become an even larger problem in the future.³

This paper presents a strategy for addressing the cash economy through administrative changes within the IRS and legislative changes to the tax law. The goal is to find solutions for improving voluntary compliance by making it easier for cash economy taxpayers to understand and meet their tax obligations, and to improve the tools available to the IRS for enforcing the tax laws when necessary.

The proposed strategy is a comprehensive approach that addresses numerous interrelated issues that impact taxpayers operating in the cash economy. It includes recommendations in the following areas:

- Overall Recommendation – Establishing a Cash Economy Program Office;
- Making Compliance Easier;
- Improving Income Visibility and the Productivity of Audits;
- Increasing the Focus on Preparers; and
- Conducting Research on Attitudes toward Tax Compliance.

A summary of the principal recommendations follows.

Overall Recommendation

The IRS should establish a Cash Economy Program Office. This office would have responsibility for implementing an overall strategy for addressing the cash economy, coordinating the use of tools for identifying the underreporting of income and nonfilers, and promoting a research agenda that addresses the unique issues associated with the cash economy.

¹ IRS, *National Research Program*, tax year 2001. The net tax gap for TY 2001 is estimated at \$290 billion, which accounts for another \$55 billion of tax revenue as the result of taxpayers paying late or from IRS enforcement actions.

² See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts). Underreporting makes up about 83 percent of the tax gap (\$285 billion of the \$345 billion gap). Underreporting of business income by individuals – from sole proprietors, rents and royalties, and passthrough entities – accounted for about \$109 billion. *Id.* Associated underreporting of self employment taxes by unincorporated businesses accounts for another \$39 billion. *Id.*

³ The IRS projects that the number of individual small business returns will grow by over 13 million by fiscal year 2014. In contrast, individual returns, with their high degree of information reporting, are expected to decrease during the same period. IRS Document 6292, *Fiscal Year Return Projections for the United States: 2007-2014* (June 2007).

Making Compliance Easier

Improve Outreach Efforts to Small Business Owners. The IRS should develop a strategic plan for improving education and outreach to small businesses similar to the Taxpayer Assistance Blueprint. Outreach activities could include workshops for new businesses, and IRS could better craft its education messages by identifying the most common filing and payment errors. The Communications, Liaison and Disclosure (CLD) organization should also ensure that its outreach and education efforts reflect demographic trends. Examples include the increasing number of sole proprietor taxpayers, self-employed individuals with language barriers, and immigrants who wish to pay their taxes but fear that the IRS will share data with immigration authorities.

Simplify Guidance on Tax Rules that Confuse Taxpayers. The IRS should conduct research to identify areas in IRS processes or guidance that cause confusion for small business taxpayers. The IRS could then issue regulations, revenue procedures or other guidance as appropriate to make it easier for taxpayers to understand their obligations and comply with the law.

Encourage More Frequent Estimated Payments through EFTPS. The IRS should encourage taxpayers to schedule weekly or monthly payments through the Electronic Federal Tax Payment System (EFTPS) to avoid the difficulty of saving money to make lump sum quarterly payments, and to avoid late payment penalties. The IRS should also consider abating a late payment penalty as an incentive for taxpayers to use EFTPS, similar to that offered in the past for Federal Tax Deposits.

Send Reminder Notices to Taxpayers for Estimated Payments. The IRS should consider sending reminder notices to taxpayers who have missed payments in the past and to encourage them to enroll in EFTPS.

Allow Voluntary Withholding Agreements Between Independent Contractors and Service Recipients. Congress should specifically authorize voluntary reporting agreements between independent contractors and service recipients.

Use Collection Alternatives. The IRS should more actively use Collection alternatives, such as partial payment installment agreements and improved access to the offer in compromise program, so that taxpayers who can pay some but not all of their liabilities are not pushed into perpetual noncompliance.

Improving Income Visibility and the Productivity of Audits

The report contains a number of recommendations intended to promote higher voluntary compliance by increasing the visibility of income and improving the productivity of audits.

A Comprehensive Strategy for Addressing the Cash Economy

Create an Income Database. The IRS should explore creating a database to combine all gross receipts-related information sources into a single system that would allow the IRS to develop new techniques for identifying potential underreporting and help auditors. In addition to information the IRS currently receives, such as Forms 1099-MISC, Miscellaneous Income Forms 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business), and information on taxpayer bank accounts, it could also include new information sources proposed in this strategy, such as credit card payments to merchant accounts, Forms 1099 for payments to 1120S corporations, and matching information on data from state and local governments.

Initiate Single Issue Gross Receipts Audits. The IRS should develop an audit program focused specifically on gross receipts and train the staff to effectively use available tools and procedures. The combination of faster audits and an enhanced ability to identify noncompliant returns (using the income database described above) should enable the IRS to directly contact the most noncompliant taxpayers in the cash economy.⁴

Require Banks to Report Existence of all Bank Accounts. Eliminating the \$10 minimum for reporting interest would allow the IRS to identify the existence of bank accounts, such as non-interest bearing checking accounts, while not expanding the type of information collected. Auditors will be more likely to have full and complete banking information, and to uncover underreporting, if they can request statements using specific bank names and account numbers. Taxpayers may also be less likely to underreport income if they know their bank must report on all of their accounts to the IRS.

Add Line on Schedules C for Form 1099 Income. The IRS should consider redesigning the Schedule C (Form 1040), Profit or Loss From Sole Proprietorship to include two separate lines for reporting income – one line for receipts shown on Forms 1099 and one for other receipts. A related proposal is to ask the taxpayer to affirmatively declare, under penalties of perjury, that he or she filed the required Forms 1099 for all payments of \$600 or more to any one individual or partnership during the calendar year.

Develop Ratios of Cash to Credit Card Receipts by Industry. The IRS could develop industry ratios on the average share of sales from cash and payment cards. The IRS could use any unexplained deviations from these ratios in combination with other criteria to select returns for audit.

Conduct Research on the Direct and Indirect Effects of Audits. The IRS should study the impact of audits in the cash economy to help determine how best to deploy limited enforcement resources to maximize compliance.

⁴ An analysis by GAO found that ten percent of sole proprietors with understated taxes accounted for 61 percent of the total tax liability. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 15 (July 2007).

Simplify the Tax Code. The complexity of the code increases the likelihood that honest taxpayers will make inadvertent mistakes, creates opportunities for taxpayers to avoid paying their fair share of taxes, and makes it difficult for the IRS to administer the tax system. Simplifying the tax law could improve the audit process and allow for less taxpayer burden.

Increasing the Focus on Preparers

The IRS needs additional research to determine the degree to which preparers impact the underreporting of gross receipts and the overstatement of expenses. If research shows that preparers do significantly impact taxpayer compliance, the IRS should investigate creating a preparer database that contains summary data on preparer characteristics, such as the number of client returns that have compliance risk scores outside expected parameters, or contain math errors, etc.

IRS could study compliance at the preparer level, evaluate “soft touch” approaches to address potential compliance issues, and undertake enforcement actions as appropriate.

Conducting Research on Attitudes toward Tax Compliance

The IRS should consider establishing a research unit devoted to exploring the effect taxpayers’ attitudes have on voluntary compliance and finding ways to positively influence those attitudes. Existing research shows that a taxpayer’s willingness to pay taxes voluntarily is not based exclusively on risk (“how likely am I to get caught if I cheat on my taxes?”) but is also influenced by personal values and social norms.⁵ Understanding these attitudes can help the IRS determine what types of education and outreach will maintain and increase voluntary compliance.

⁵ Margorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*, *supra*.

A Comprehensive Strategy for Addressing the Cash Economy

Introduction

In recent years, there has been growing consensus that the tax gap is a significant challenge facing our tax system. The National Taxpayer Advocate has addressed the tax gap in testimony before Congress as well as in her Annual Reports to Congress.⁶ In 2006, the National Taxpayer Advocate identified the issue as the number two Most Serious Problem facing taxpayers.⁷

The tax gap has been the focus of studies by the Government Accountability Office (GAO) and Treasury Inspector General for Tax Administration (TIGTA).⁸ The IRS released “Reducing the Federal Tax Gap – A Strategic Plan to Improve the Level of Voluntary Compliance” in July 2007.⁹ This plan expands on the Treasury Department’s high-level Comprehensive Strategy for Reducing the Tax Gap and provides additional detail on specific actions to address the problem.¹⁰

The IRS estimates that the gross tax gap – the difference between what taxpayers owe and what they pay voluntarily and timely – amounted to \$345 billion in tax year 2001.¹¹ Additional revenue collected from late payments and IRS enforcement actions reduces the net gap to \$290 billion. *Dividing the net tax gap of \$290 billion by an estimated 108,209,000 U.S. households¹² results in an average “surtax” of \$2,680 on every household to subsidize noncompliance.*

Aside from the vast sum of taxes never paid to the government, the tax gap is a serious issue because it undermines confidence in our tax system. Failing to act to reduce the tax gap could further erode compliance if compliant taxpayers decide they are “tax chumps” for meeting their tax obligations when they perceive others do not.

⁶ The National Taxpayer Advocate has testified at the following congressional hearings focused on the federal tax gap: House Budget Committee (Feb. 16, 2007); Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Sept. 26, 2006); Senate Finance Subcommittee on Taxation and IRS Oversight (July 26, 2006); Senate Budget Committee (Feb. 5, 2006); Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information, and International Security (Oct. 26, 2005) (written statement only); Senate Finance Committee (Apr. 4, 2005); Senate Finance Committee (July 21, 2004).

⁷ National Taxpayer Advocate 2006 Annual Report to Congress 6-9. See also National Taxpayer Advocate 2005 Annual Report to Congress 55-75 (discussing the cash economy) and 381-396 (making legislative proposals to improve compliance in the cash economy); National Taxpayer Advocate 2004 Annual Report to Congress 211-263 (discussing IRS examination strategy, IRS collection strategy, and the application of the Federal Payment Levy Program to noncompliant federal contractors) and 478-489 (making legislative recommendations to combat the tax gap, which includes a chart identifying and commenting on 24 options); National Taxpayer Advocate 2003 Annual Report to Congress 20-25 (discussing noncompliance by self-employed taxpayers) and 256-269 (proposing tax withholding on non-wage workers, a position the National Taxpayer Advocate subsequently modified in her 2005 report cited above in this footnote).

⁸ Examples include Government Accountability Office, GAO-05-753, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap* (July 18, 2005). Statement of Russell George, Treasury Inspector General for Tax Administration, *A Closer Look at the Size and Sources of the Tax Gap*, U.S. Senate Committee on Finance, Subcommittee on Taxation and IRS Oversight (July 26, 2006). See Bibliography for a more complete listing of GAO and TIGTA reports.

⁹ IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007).

¹⁰ U.S. Department of the Treasury, Office of Tax Policy, *A Comprehensive Strategy for Reducing the Tax Gap* (Sept. 27, 2006).

¹¹ IRS, *National Research Program*, Tax Year 2001. The net tax gap for TY2001 is estimated at \$290 billion which accounts for another \$55 billion of tax revenue as the result of taxpayers paying late, or from IRS enforcement actions.

¹² U.S. Census Bureau, Population Division (data as of March 2001).

The National Taxpayer Advocate believes the portion of the tax gap attributed to the cash economy deserves special attention because of its size and the likelihood that it will become an even larger problem in the future. This paper presents a strategy for addressing the cash economy component of the tax gap through administrative changes within the IRS and legislative changes to the tax law. The Taxpayer Advocate Service developed this strategy after a comprehensive review of previous studies and other relevant literature from a wide variety of sources.¹³

It is critical that the IRS gain a better understanding of taxpayer behavior and the causes of noncompliance, and many proposals contained in this strategy focus on building a knowledge base in this area. It does not make sense to simply devote additional enforcement resources toward the tax gap if the IRS lacks a broader understanding of why taxpayers are noncompliant, and what approaches will be most effective in encouraging voluntary compliance.¹⁴

This report is posited on three assumptions. First, taxpayers deserve an effective tax system that allows them to determine with confidence that they arrived at the correct tax through the use of clear instructions and simple processes. Second, taxpayers deserve a system that ensures all taxpayers are paying their share and provides the IRS with the necessary tools to address intentional noncompliance. Third, when ensuring that all taxpayers pay their share, the IRS uses tools that are narrowly targeted to the particular noncompliance at issue (and its causes), that impose the least possible burden on taxpayers, and that respect taxpayers' rights.

Composition of the Tax Gap

The gross tax gap of \$345 billion is comprised of three types of noncompliance:

- Failure to report all income;
- Failure to pay all tax due; and
- Failure to file a tax return.

¹³ Many of the sources were identified during a joint task force effort with the Small Business/Self Employed Division (SB/SE). This strategy, however, solely reflects the views of the Taxpayer Advocate Service. See Appendix B for a complete bibliography.

¹⁴ Dustin Stamper, *New Findings on the Way from 2001 IRS Research, Mazur Says*, Tax Notes Today, 2007 TNT 121-6 (June 22, 2007) (noting comments of Eric Toder, Urban Institute Senior Fellow, and Mark Mazur, IRS Director of Research, Analysis and Statistics, that better methods for identifying noncompliance and ways to improve voluntary compliance are needed).

A Comprehensive Strategy for Addressing the Cash Economy

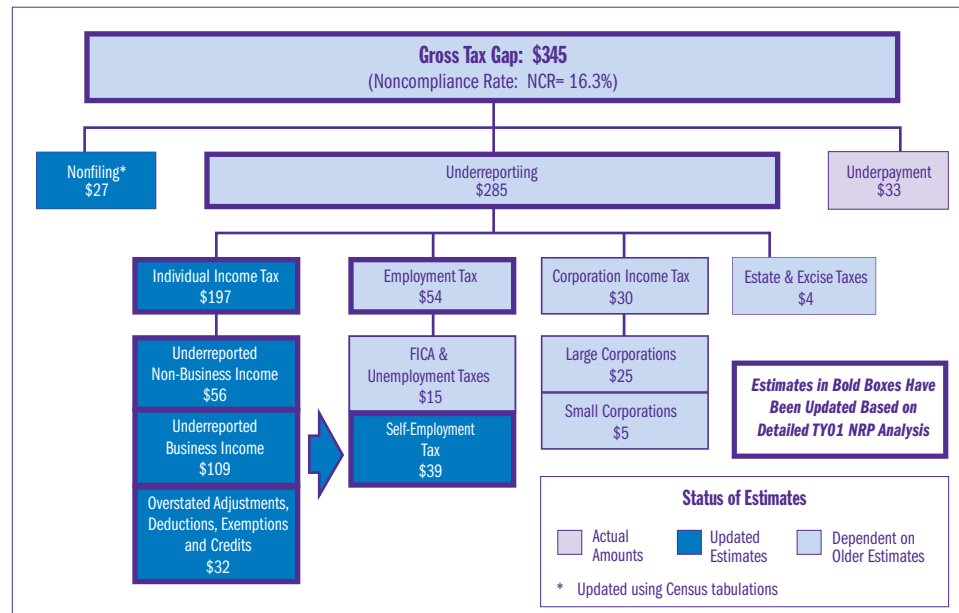
FIGURE 1, Tax Year 2001 Federal Tax Gap (In Billions Of Dollars)¹⁵

Figure 1 shows that employment tax, corporate income tax, and estate and excise taxes all contribute to the underreporting tax gap. However, the \$197 billion underreported by individuals is by far the largest component, accounting for 69 percent of the total dollars attributed to underreporting.

What is the Cash Economy?

Although there is no universally agreed-upon definition of “cash economy,” we use the term to mean taxable income from legal activities that is not reported to the IRS by third parties. This definition can include businesses dealing strictly in cash, as well as others that handle a portion of their transactions in cash or receive other payments not subject to information reporting. For example, a retailer who receives most of his revenue through debit and credit cards can be considered part of the cash economy, because these forms of payment are not subject to reporting.

Why Focus on the Cash Economy?

The IRS released a strategy for addressing the tax gap in 2007¹⁶, so why devote special attention to the cash economy? The cash economy is the largest contributor to the tax gap, will continue to grow, and is the area the IRS is least able to address through existing enforcement techniques.

¹⁵ IRS, *National Research Program, Tax Year 2001*. See Appendix A for a more detailed chart on the tax gap.

¹⁶ IRS, *Reducing the Federal Tax Gap – A Report on Improving Voluntary Compliance* (Aug. 2, 2007).

Cash Economy Businesses Account for Largest Category of Misreporting

Underreported business income by individuals accounts for the largest single segment of the tax gap. As shown in Figure 1, the IRS attributes \$109 billion of the \$285 billion tax gap from underreporting (38 percent) to underreported business income by individuals. This income segment meets our definition of the cash economy, since it is subject to a low degree of information reporting. An analysis by the Government Accountability Office found only one quarter of sole proprietors' receipts were reported to the IRS on a Form 1099-MISC.¹⁷

Cash Economy Expected to Grow

Changes in the economy and financial markets suggest a need for additional focus on the cash economy. Income sources not subject to information reporting have grown significantly, and are expected to grow further. In 1980, 8.7 percent of total reported income was not subject to third party reporting. By 2000, this percentage had more than doubled to 18.4 percent. The primary factor in this increase was the faster relative growth in the nonmatchable components of net taxable capital gains and partnership and small business net income.¹⁸

In addition to these structural shifts in income sources, the IRS projects that the number of individual small business returns will grow by over 13 million by fiscal year 2014. In contrast, other individual returns, with their high degree of information reporting, are expected to decrease during the same period.

TABLE 1, Estimated Number of Returns by Type¹⁹

Type of Return	FY2006 Actual	FY2014 Projected	Change	Percent
Individual	93.1M	91.4M	-1.7M	-1.8%
Small Business/Self Employed	40.1M	53.3M	+13.3M	+33.1%

IRS Has Fewer Tools for Addressing the Cash Economy

One of the IRS's primary tools for monitoring compliance is matching the income information on tax returns to information provided by third parties such as employers, banks, and other entities. However, the IRS's ability to verify income levels is not equal for all types of taxpayers.

¹⁷ Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 17 (July 2007).

¹⁸ Kim Bloomquist, *Trends as Changes in Variance: The Case of Tax Noncompliance*, presented at the 2003 IRS Research Conference, June 2003. Bloomquist notes the stock market bubble of the late 1990s contributed greatly to growth in financial assets. Between 1995 and 2000, the share of taxpayer reported net capital gains increased from four percent to 9.5 percent of total income.

¹⁹ IRS Document 6292, *Fiscal Year Return Projections for the United States: 2007-2014* (Rev. Sept. 2007). The Small Business/Self Employed figures reflect taxpayers filing a Form 1040 return with a Schedule C (Profit or Loss From Business), Schedule F (Profit or Loss From Farming); Schedule E (Supplemental Income and Loss); Form 2106 (Employee Business Expenses); or with mailing addresses or forms considered "International." *Id.*

A Comprehensive Strategy for Addressing the Cash Economy

Table 2 below shows the strong correlation between the degree of information reporting and the accuracy of returns. The net misreporting percentage for income is the aggregate amount of income that was not reported correctly on the return divided by the aggregate amount that should have been reported.²⁰ Income sources with a lower level of information reporting have higher rates of misreporting.

TABLE 2, Net Misreporting Gap by Level of Information Reporting²¹

Level of Information Reporting	Examples	Net Misreporting Gap (\$B)	Net Misreporting Percentage
Substantial Reporting and Withholding	Wages, salaries	\$10	1%
Substantial Reporting	Interest, dividends, pensions	\$9	5%
Some Reporting	Partnerships, alimony, capital gains, deductions	\$51	9%
Little or No Reporting	Nonfarm proprietor income, rents, other income	\$110	54%

Simply put, compliance is highest where third-party information reporting is highest.

Challenges in Addressing the Tax Gap

The challenges in addressing the cash economy tax gap are many. There are strong interests that argue against any type of increased information reporting due to concerns about increased burden. Limited resources within the IRS also make implementing new initiatives tougher.

Despite these challenges, the National Taxpayer Advocate believes it is unacceptable to do nothing beyond current efforts to address the cash economy tax gap. The goal of this cash economy strategy is to find solutions for improving voluntary compliance by making it easier for cash economy taxpayers to understand and meet their tax obligations, and to improve the tools available to the IRS for enforcing the tax laws when necessary.

Readers should evaluate these proposals in light of the seriousness of the tax gap and should consider both the burden on taxpayers and the benefits to an effective tax system. Benefits should include not just the direct impact on the Treasury, but also the indirect benefits of allowing businesses to compete on a more even footing so honest taxpayers are not placed at a disadvantage to their less scrupulous peers.

The remainder of this strategy presents recommendations for addressing the cash economy tax gap, with the proposals grouped under the major compliance categories:

- Improving Income Reporting Compliance;
- Improving Payment Compliance; and
- Improving Filing Compliance.

²⁰ For example, a taxpayer reporting only \$70 of income when the true figure was \$100 would result in a net misreporting percent of 30 percent.

²¹ IRS, *National Research Program*, Tax Year 2001.

We have grouped individual proposals where we believe they will have the biggest impact, but many have benefits beyond a single category. Before presenting the categories, we first offer an overall recommendation.

Create a Cash Economy Program Office

The IRS should establish a Cash Economy Program Office that would have responsibility for overseeing and coordinating efforts to address noncompliance in the cash economy.²² A Cash Economy Program Office would be charged with:

- Implementing an overall strategy for addressing the cash economy, including partnerships with state governments;
- Coordinating the use of tools for identifying the underreporting of income and potential nonfilers; and
- Promoting a research agenda that addresses the unique issues associated with the cash economy.

The program office would also consolidate enforcement and outreach efforts to address the cash economy, which are now dispersed throughout the IRS. A Cash Economy Program Office could bring together both existing programs and those proposed in this strategy and provide the direction and oversight needed to reduce this largest component of the tax gap. The head of the office would be responsible for coordinating its activities and championing its initiatives within the IRS.

Improving Income Reporting Compliance

This section presents options for addressing the \$109 billion of the tax gap caused by the underreporting of individual business income. Together, these proposals could greatly improve the IRS's ability to detect noncompliant behavior and focus its limited enforcement resources. We present options under the categories of:

- Making reporting compliance easier;
- Improving the visibility of business income;
- Improving the productivity of audits;
- Conducting research on the direct and indirect effects of audits;
- Increasing the focus on preparers; and
- Conducting research on attitudes towards tax compliance.

²² The National Taxpayer Advocate previously recommended creating a Cash Economy Program Office in her 2005 Annual Report to Congress. The IRS did not agree that creating a program office would be an efficient way to address noncompliance in the cash economy. The IRS did acknowledge that a comprehensive and well-coordinated strategy among various IRS offices might be successful in addressing the issue of the cash economy, but that it was premature until the new National Research Program (NRP) data became available. (National Taxpayer Advocate 2005 Annual Report to Congress 73.) The National Taxpayer Advocate believes that NRP tax gap estimates, which suggest that significant noncompliance exists in the cash economy, justify creating a unit devoted to addressing noncompliance in the cash economy.

Making Reporting Compliance Easier

Improve Outreach Efforts to Small Business Owners

The National Taxpayer Advocate believes voluntary compliance can be significantly improved if taxpayers are given the support they need to fully understand and correctly calculate their tax obligations.²³ To achieve this goal, the IRS should enhance its current level of service with outreach and education programs.

The IRS should develop a strategic plan for improving education and outreach to small businesses similar to the Taxpayer Assistance Blueprint.²⁴ Outreach activities could include providing workshops for new recipients of Employer Identification Numbers (EINs) or first time Schedule C filers. These workshops would educate taxpayers on all the requirements for properly filing and reporting employment taxes, outline payment options, and provide a forum for addressing the concerns of new business owners. The IRS could better craft its educational messages by conducting research to identify the most common filing and payment errors made by small business taxpayers.

Simplify Guidance on Tax Rules that Confuse Taxpayers

The IRS should conduct research to identify areas in IRS processes or guidance that cause confusion for small business taxpayers. The IRS could then issue regulations or revenue procedures as appropriate to make it easier for taxpayers to understand their obligations and comply with the law.²⁵

The IRS Office of Chief Counsel regularly requests input from stakeholders in formulating its Priority Guidance Plan. However, more focused efforts to identify issues of concern to small business taxpayers and preparers could produce guidance that positively impacts cash economy taxpayers.

Improving the Visibility of Business Income

Create an Income Database

The information the IRS receives from third party reporting data is used separately in different IRS functions. Combining all information sources into a single information system

²³ For a more detailed description of the challenges faced by small business taxpayers, see National Taxpayer Advocate 2006 Annual Report to Congress 172-196 (Most Serious Problem – Small Business Outreach).

²⁴ IRS Pub. 4579, *The 2007 Taxpayer Assistance Blueprint – Phase 2* (April 2007). The Taxpayer Assistance Blueprint is an assessment of how services are delivered to individual taxpayers and provides a strategic plan for future service delivery and research. A cross-functional team, which included representatives from the Taxpayer Advocate Service, the Wage and Investment Operating Division, and Governmental Liaison and Disclosure, recently outlined a research and outreach plan for business taxpayers which included a recommendation that SB/SE should develop a five-year strategic plan to enhance the outreach and education provided to small business taxpayers. Memorandum for Director, Communications Liaison and Disclosure, from Task Force to Enhance Small Business Outreach, *Enhancing Outreach and Education to Small Business Taxpayers* (Sept. 4, 2007).

²⁵ As an example, the IRS Office of Taxpayer Burden Reduction established a team to address simplification of the home office deduction. See National Taxpayer Advocate 2007 Annual Report to Congress, Vol. I (Key Legislative Recommendation – Home Office Business Deduction).

would allow the IRS to develop new techniques for identifying potential underreporting and could help auditors improve efficiency.²⁶

This database could organize information by taxpayer, and should include all relevant existing information sources on business income, such as Forms 1099-MISC and 8300. It could also include new information sources proposed in this strategy, such as credit card payments to merchant accounts, Forms 1099 for payments to small corporations, matching information on data from state and local governments, and information on taxpayer bank accounts (discussed below).

Creating a new database without diverting resources from the IRS's current modernization efforts would be a significant challenge. Before committing to a new system, the IRS should conduct a pilot study that pulls together a limited number of records from the data described above, and should explore development of algorithms and procedures for identifying potential noncompliance. In the pilot, the IRS should address the following questions:

- Can the IRS develop algorithms that identify potential underreported income?
- Can the algorithms work using existing IRS data, or is additional information reporting data necessary?
- Does the information in the system result in more efficient and accurate audits when supplied to the auditor?

Before implementing new reporting requirements, the IRS must also weigh taxpayer burden against the potential compliance impact. The IRS should not impose new reporting requirements if the pilot does not demonstrate the potential to significantly improve compliance.²⁷

Require Reporting on Credit Card Payments to Merchants

The U.S. economy is increasingly becoming a cashless system. A 2005 survey of consumers revealed that cash and checks accounted for 45 percent of payments, down from 57 percent in 2001, and that the rate of change from cash to other methods is quickening.²⁸ The term "payment cards" describes the general category of "plastic" payments, which includes credit cards, debit cards, gift cards, and prepaid cards. These types of cards handled purchases of \$2.6 trillion in 2005, with the total expected to rise to over \$4.7 trillion in 2010.²⁹

²⁶ The IRS developed the Unreported Income Discriminant Function (UIDIF) program in FY 2004 which scored tax returns according to the potential for understated income. After a pilot phase, the program was discontinued due to its limited utility, delays in selecting cases, and cost of classifying returns. IRS response to TAS for 2005 Annual Report to Congress (Dec. 23, 2005).

²⁷ If the pilot is successful, the IRS may need to request additional resources through the budget process to build the income database.

²⁸ American Bankers Association and Dove Consulting, *Consumer Payment Preferences*, reporting on the *2005/2006 Study of Consumer Payment Preferences* (Oct. 2005). Results are based on a survey of 3,008 respondents.

²⁹ *The Nilson Report, Issue 865 7* (Sept. 2006).

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Payments to a merchant should be reported to the IRS in the same fashion as banks report interest payments. While not all merchants are paid using payment cards, this data would allow the IRS to identify instances where a merchant may be underreporting gross sales and should capture a great deal of commercial activity, including much of the rapidly growing Internet economy.³⁰

The Department of the Treasury recommended a legislative change requiring information reporting on merchant payment card reimbursements in its fiscal year 2008 revenue proposals.³¹ While the specifics of the proposal remain to be fleshed out, the National Taxpayer Advocate supports the thrust of the proposal and urges Congress to enact it.

Require Banks to Report Existence of All Individual and Merchant Bank Accounts

A common request by the IRS during an audit is for the taxpayer to provide copies of bank statements, which include critical information for analyzing deposits and investigating income issues. Auditors would be more likely to have full and complete banking information, and to uncover underreporting, if they could request statements using specific bank names and account numbers. While it is possible to avoid using a bank account when operating on a purely cash basis, this option is not practical for the vast majority of businesses.

In addition, reporting the existence of all bank accounts would likely have a positive impact on voluntary compliance. Taxpayers may be less likely to underreport income if they know their bank must report on all of their accounts to the IRS.

Implementing a requirement for banks to report on the existence of a bank account to the IRS involves no additional burden for individual or business taxpayers. Banks must already report interest income of \$10 or more annually to the IRS.³² Eliminating the \$10 minimum would allow the IRS to identify the existence of bank accounts, such as non-interest bearing checking accounts, while not expanding the type of information collected.

Require 1099 Reporting for Small Corporations

Businesses must report monies paid to non-employees – above \$600 annually – to the IRS,³³ unless the recipient is a corporation.³⁴ Eliminating this exception for small corporations would subject them to the same requirements as employees and non-corporations.³⁵ We

³⁰ Credit and debit cards account for 80 percent of internet payments, with an additional nine percent from peer-to-peer services such as PayPal. American Bankers Association and Dove Consulting, *Consumer Payment Preferences*, reporting on the *2005/2006 Study of Consumer Payment Preferences* (Oct. 2005).

³¹ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* 66 (Feb. 2007).

³² IRC § 6049.

³³ IRC § 6041. Monies paid to employees in the form of wages and salaries are reported to the IRS on Form W-2. Payments to businesses are reported to the IRS on Form 1099-MISC.

³⁴ Treas. Reg. § 1.6041-3(p)(1).

³⁵ See Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy*, vol. 1, *supra*.

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see no reason to provide an exception for closely held corporations given the strong correlation between third party information reporting and voluntary compliance.

This proposal should be implemented contingent on evidence that substantial noncompliance exists among small corporations. Tax gap estimates for corporations are based on older data, and thus may not be reliable. The IRS's National Research Program is researching noncompliance on Form 1120S returns to obtain more current estimates.³⁶

The IRS should consider developing an online system that identifies whether an entity is subject to the Form 1099 reporting requirement. This interactive system would enable payors to determine which entities they need to report on, and allow the selective extension of Form 1099 reporting to other corporate entities if necessary. The IRS may be able to add the reporting requirement feature to its existing e-Services Online TIN (Taxpayer Identification Number) Matching Program.³⁷ It might also be possible to deploy a similar system accessible over the phone to service taxpayers who do not have internet access.

Reverse Matching against State and Local Data

The IRS should expand data sharing with state revenue agencies. Sales tax data reported to the states can be used to determine if the taxpayer is consistent in reporting gross receipts to the state and the IRS.³⁸ The IRS could also explore matching against other data such as business license tax filings, real estate, and motor vehicle registry information.³⁹

One IRS study matched sales tax data from Iowa against gross receipts reported to the IRS. The study found 2,607 instances where the gross sales reported to the state exceeded the gross receipts reported to IRS by \$100,000 or more, and 304 cases where the difference was greater than \$1 million.⁴⁰ While there may be valid reasons why the figures differ, this research demonstrates the potential for more active data sharing.⁴¹

³⁶ The administration made a similar proposal to require Form 1099 reporting for corporations. The proposal notes, "Although the exception for information reporting to corporations is set forth in existing regulations, because it has been in place for many years and because Congress, during that time period, has made numerous changes to the information reporting rules, elimination of the exception should be made by legislative change." Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2008 Revenue Proposals* (a.k.a., 2007 Blue Book) 63 (Feb. 2007).

³⁷ The e-Services Online TIN Matching Program allows authorized payors to verify taxpayer identification numbers. See IRS Pub. 2108-A, *e-Services On-Line TIN Matching Program* (May 2004).

³⁸ All but five states have a sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon. Federation of Tax Administrators, *2006 State Tax Collection by Source*, at <http://www.taxadmin.org/fta/rate/06taxdis.html> (last visited Sep. 14, 2007). IRS data sharing arrangements have generally focused on audit data. See IRS Seeking Increased Taxpayer Data Sharing With States, 2007 TNT 177-4 (Sept. 12, 2007) and IRS and States to Share Employment Tax Examination Results, 2007 TNT 216-12 (Nov. 6, 2007).

³⁹ The IRS should consider getting lists of license holders in industries where there is a sizeable cash economy component, even if the state or locality does not collect gross receipts information in connection with the license. The IRS could use lists of licenses that help taxpayers generate income to identify potential nonfilers. Examples include liquor licenses, contractor licenses, cosmetology licenses, real estate licenses, taxi medallions, and street vending licenses (this list is for explanatory purposes only and is not meant to suggest a high degree of noncompliance in these segments).

⁴⁰ IRS, Small Business/Self-Employed Division Research, Project BKN0048, *Matching State of Iowa Sales Tax Data Against Gross Receipts Reported to IRS* (Feb. 2007). The figures cited include taxpayers who filed Schedule C's, Form 1065 U.S. Return of Partnership Income, Form 1120 U.S. Corporation Income Tax Return, or Form 1120S (S Corporation).

⁴¹ State and federal tax laws may differ in the definition of what revenue sources are counted in gross receipts.

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The IRS could also use information on licenses to determine if taxpayers are filing their required federal returns. For example, many states license construction contractors. Another option is to encourage states and local governments to make compliance with the federal tax laws a prerequisite for obtaining or renewing a license.⁴²

It is no small challenge to develop a matching program capable of handling data exchanges from multiple jurisdictions.⁴³ The National Taxpayer Advocate urges the IRS to continue to expand its efforts in this area and to build the program over time, so that the IRS addresses these challenges in a way that is efficient, accurate, and imposes the least burden on taxpayers.⁴⁴

Add Line on Schedules C for Form 1099 Income

Sole proprietors report their business income by attaching Schedule C (Profit or Loss From Business) to their Forms 1040 (Individual Income Tax Return) and report gross receipts on Line 1 of Schedule C. However, the form does not distinguish among types and sources of income. The IRS should consider redesigning the Schedule C to include two separate lines for reporting income – one line for receipts shown on Forms 1099 and one for other receipts.

Including separate lines will make clear to the taxpayer that he or she must account for all types of income, both cash and 1099 income. The change will also enable the IRS to conduct more accurate income matching. Line 1 now includes all types of income, which in many cases will not match the income reported on Forms 1099.

A related proposal is to ask the taxpayer to affirmatively declare, under penalties of perjury, whether he or she paid more than \$600 to any one individual or partnership during the calendar year. An affirmative answer would require the taxpayer to indicate whether he or she reported these payments on the appropriate Forms 1099.

Adding these two questions directly confronts the taxpayer with the requirement to file income reports. Taxpayers who are unaware of the requirement or do not believe it applies to them would at least have to determine how these questions apply to them.

⁴² Some states require compliance with the state tax authority. For example, Pennsylvania requires certification that all state tax returns have been filed and paid in full before issuing certain licenses. See <http://www.dli.state.pa.us/landi/cwp/view.asp?a=362&q=238059#lic>. We would ask states to implement a similar requirement that license holders be compliant with their federal taxes.

⁴³ A significant challenge will be determining how to analyze corporation data where there may be subsidiaries that file state returns but their income is reported in the parent corporation at the federal level.

⁴⁴ The IRS has investigated the potential for using state tax amnesty data. See Small Business/Self-Employed Division Research – Brooklyn/Hartford, Project BKN0029, *Closing the Tax Gap with State Tax Amnesty Data* (May 2006).

The IRS previously rejected these proposals. However, the National Taxpayer Advocate encourages the IRS to implement these recommendations immediately.⁴⁵

Develop Ratios of Cash to Credit Card Receipts by Industry

As noted earlier, not all transactions are completed using payment cards. The IRS could develop industry ratios on the average share of sales from cash and payment cards, with appropriate breakouts that account for the size of the business. The IRS could use any unexplained deviations from these ratios in combination with other criteria to select returns for audit. For example, online sellers may receive 90 percent or more of their revenue through payment cards while other retail shops may receive only 60 percent.

Capture Information from Forms 8300

Retailers are required to report cash payments of over \$10,000 to the IRS on Form 8300, of which the IRS received nearly 162,000 in calendar year 2006.⁴⁶ These forms help the IRS detect the possible existence of income for the person or business making a cash purchase even if it is not covered by other reporting. The Form 8300 data can be particularly useful in identifying taxpayers dealing solely in cash even when they do not have bank accounts.

The IRS currently uses this information for investigating possible violations of the Bank Secrecy Act.⁴⁷ Adding this information to the business income database described earlier could improve the system's ability to identify unreported income and provide better information to examiners should an audit take place. The IRS should also study whether other currency reporting sources included in the Currency and Banking Retrieval System should be added to the income database.⁴⁸

Improving the Productivity of Audits

A significant challenge in addressing the cash economy is that traditional enforcement actions are either ineffective or costly in time and resources.⁴⁹ Currently, the IRS has two programs for investigating suspected noncompliance.

The Automated Underreporter (AUR) program uses third party reporting documents to identify returns where income is understated. The strength of the program is that it can "touch" a large number of taxpayers using minimal resources. However, while AUR is ef-

⁴⁵ National Taxpayer Advocate 2005 Annual Report to Congress 55-75. The IRS disagreed with the proposals citing that accounting systems ordinarily do not separate Form 1099 and non-Form 1099 income, it would be costly and burdensome for taxpayers, adding lines runs counter to the Paperwork Reduction Act, and that the Form 1040 Schedule C instructions already inform the taxpayer of the filing requirements and refer the taxpayer to the General Instructions for Forms 1099, 1098, 5498 and W-2G, catalog # 11409F.

⁴⁶ IRS, *Currency Reporting - Money Laundering*, at <http://www.irs.gov/compliance/enforcement/article/0,,id=113003,00.html> (last visited 9/10/2007).

⁴⁷ IRM 4.26.4.

⁴⁸ Other documents included in the Currency and Banking Retrieval System include Currency Transaction Reports, Casino Currency Transaction Reports, and Foreign Money Instrument Reports. IRM 4.26.4 (Nov. 17, 2006).

⁴⁹ Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* (July 2007).

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fective for wage earners with a high degree of information reporting and withholding, it is much less effective in addressing understated gross receipts.⁵⁰

The Examination program conducts two types of audits. Correspondence audits account for the majority of examinations – 62 percent of individual non-farm business return examinations in FY 2006⁵¹ – and deal with simple issues that exclude many of the more complex Schedule C matters. Field (face-to-face) audits handle more complex issues, but take longer to complete and “touch” fewer businesses.⁵²

Initiate Single Issue Gross Receipts Audits

The National Taxpayer Advocate recommends that the IRS develop an audit program focused specifically on gross receipts and train the staff to effectively use the available tools and procedures to probe this issue.

Audits devoted solely to gross receipts offer the IRS an opportunity to effectively address the cash economy tax gap. An analysis by GAO found that ten percent of sole proprietors with understated taxes accounted for 61 percent of the total tax liability.⁵³ The combination of faster audits and an enhanced ability to identify noncompliant returns (using the income database described earlier) should enable the IRS to directly contact the most noncompliant taxpayers in the cash economy.

A risk of “single issue” audits is that they ignore other possible issues on the tax return, which can have the effect of giving the taxpayer a “green light” to continue noncompliant behavior. The IRS must balance that risk with the critical need to address the large cash economy tax gap. This proposal aims to address the tax gap by focusing resources on a known problem area.

If the IRS initiates single-issue gross receipts audits, it will need to make policy decisions on how to handle additional issues that may surface. For example, if a business restates its expenses once the IRS uncovers a new tax liability, should the IRS accept the expenses without further investigation or expand the audit?⁵⁴

⁵⁰ GAO reports that only 25 percent of sole proprietor receipts appear on a Form 1099. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 17 (July 2007). See also *Most Serious Problem, Automated Underreporter*, *supra*.

⁵¹ IRS, *2006 Data Book*, Pub. 55B, Table 9 (Mar. 2007). “Field audits” include audits conducted in an IRS office or at the taxpayer’s place of business.

⁵² The IRS has increased examinations of non-farm businesses in recent years, and field examinations are a greater share. There were approximately 113,000 field examinations of non-farm businesses in FY 2006, accounting for 38 percent of audits in this segment. IRS, *2006 Data Book*, Pub. 55B, Table 9 (Mar. 2007). This is up from 43,000 in FY 2004 (23 percent of audits) (IRS, *2004 Data Book*, Pub. 55B, Table 10 (Mar. 2005)), and 26,000 in FY 2002 (19 percent of audits) (IRS, *2002 Data Book*, Pub. 55B, Table 9 (Nov. 2003)).

⁵³ Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 15 (July 2007).

⁵⁴ The IRS might consider the type of issue in determining a course of action. For example, GAO found that while misreporting of expenses was spread over 23 expense categories on the Schedule C, 55 percent was concentrated in four categories: car and truck, depreciation, supplies, and other. Government Accountability Office, GAO-07-1014, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* 10 (July 2007).

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Simplify the Tax Code

The National Taxpayer Advocate designated the complexity of the tax code as the single most serious problem facing taxpayers in the 2004 Annual Report to Congress,⁵⁵ and believes complexity is a real and significant barrier to reducing the tax gap. The complexity of the code has created three unintended consequences.

1. Complexity increases the likelihood that honest taxpayers will make inadvertent mistakes;
2. Complexity creates opportunities for taxpayers to avoid paying their fair share of taxes; and
3. Complexity makes it difficult for the IRS to administer the tax system.

Much of the debate on complexity appropriately focuses on taxpayer burden but gives less attention to the challenges created for the IRS. The IRS must help taxpayers understand the nearly 1.4 million word tax code,⁵⁶ train employees to assist taxpayers seeking help, and identify and pursue noncompliant taxpayers.

Where an examination is necessary, simpler rules can produce more efficient audits that require less time for the taxpayer and the IRS. Former Assistant Treasury Secretary for Tax Policy Pam Olson has noted, "...Complexity in the tax law makes audits inefficient, slow, and difficult. Simplifying the tax law would improve the audit process immeasurably."⁵⁷ In 2006, the average field audit of an individual taxpayer consumed nearly 30 hours of IRS staff time.⁵⁸

The benefits of simplification have been addressed by the GAO⁵⁹ and TIGTA,⁶⁰ and were a core tenet of the proposals from the President's Advisory Panel on Federal Tax Reform.⁶¹

⁵⁵ National Taxpayer Advocate 2004 Annual Report to Congress, 2-7. The report describes the impact of complexity on all aspects of tax administration – customer service, tax return preparation, IRS processing, tax law and the tax gap, and taxpayer rights – and served as an overall theme of the entire report.

⁵⁶ The Internal Revenue Code consists of approximately 1,395,000 words. Joint Committee on Taxation, JCS-3-01, *Study of the Overall State of the Federal Tax System and Recommendation for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume I: Study of the Overall State of the Federal Tax System 4* (April 2001).

⁵⁷ Comments of Pamela F. Olson, at tax gap conference sponsored by the American Bar Association, American Institute of Certified Public Accountants, American Tax Policy Institute, Tax Executives Institute, and the American College of Tax Counsel (June 22, 2007). *Tax Gap: Speakers Support Multifaceted Approach, Incremental Steps to Combat the Tax Gap*, BNA Daily Tax Report, June 25, 2007, and information received from Pamela Olson (Aug. 30, 2007).

⁵⁸ Small Business/Self-Employed *Business Performance Review 8*, January 31, 2007. The FY 2006 average revenue agent hours per return of 29.6 is down from 37.7 in FY 2005, and 44.3 in FY 2004. Small Business/Self-Employed *Business Performance Review 7*, February 1, 2006. This decrease may suggest the typical audit is being conducted less intensively in order to increase the number of returns examined. See Eric Toder, *Reducing the Tax Gap: The Illusion of Pain-Free Deficit Reduction*, 12 (July 2007). Additionally, we note that the IRS does not collect statistics on the number of hours taxpayers spend on an audit.

⁵⁹ See, for example, Statement of David M. Walker, Comptroller General of the United States, *Business Tax Reform: Simplification and Increased Uniformity of Taxation Would Yield Benefits*, before the Committee on Finance, U.S. Senate, GAO-06-1113T (Sept. 20, 2006), and Statement of Michael Brostek, Director, Tax Issues, Government Accountability Office, *Tax Compliance: Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, before the Subcommittee on Taxation and IRS Oversight, Committee on Finance, U.S. Senate, GAO-06-1000T (July 26, 2006).

⁶⁰ See, for example, Statement of Russell George, Treasury Inspector General for Tax Administration, *A Closer Look at the Size and Sources of the Tax Gap*, before the U.S. Senate Committee on Finance, Subcommittee on Taxation and IRS Oversight (July 26, 2006).

⁶¹ President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005). The panel recommended simplifying recordkeeping for small businesses by basing it on receipts and expenses, and expanding expensing of assets.

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The burden created by complexity hits small business owners particularly hard. A Small Business Administration study notes the cost of tax compliance is 67 percent higher for small firms than large corporations.⁶²

The National Taxpayer Advocate frequently makes legislative proposals that would simplify the Internal Revenue Code and make it easier for businesses to meet their tax obligations. To illustrate, she has recommended that Congress:

- Allow married couples operating a business as co-owners to elect out of subchapter K of the Code and file one Schedule C to avoid the complex recording-keeping requirements for Form 1065;⁶³
- Repeal the Alternative Minimum Tax (AMT) for individuals because it is impacting taxpayers it was never intended for, and the complexity of the AMT is such that many taxpayers are caught unaware until they prepare their returns;⁶⁴
- Eliminate or simplify phase-outs because they create confusion and have unintended policy implications;⁶⁵ and
- Allow a small business corporation to elect to be treated as a subchapter S corporation in conjunction with timely filing its first Form 1120S.⁶⁶ This change will eliminate the drastic consequences for late filed elections in the first year of operations.

Conducting Research on the Direct and Indirect Effects of Audits

Past research has attempted to estimate the effects of audits.⁶⁷ The direct effects are the adjustments to tax liabilities as a result of audits. Indirect effects cover the estimated “ripple effect” of the audit on the taxpayer in subsequent years and on the taxpayer’s family and associates. To address the tax gap, the IRS needs to determine:

- How does the fear of an audit (*i.e.*, the indirect effect) influence the behavior of those in the various business segments that comprise the cash economy?
- Is the direct impact of correspondence and field audits in the cash economy similar, or is one of those approaches clearly more effective?
- How does the impact of these audits compare between industries? For example, are correspondence audits effective for retail businesses, but ineffective in the construction industry?

⁶² W. Mark Crain, under contract with the Small Business Administration, *The Impact of Regulatory Costs on Small Firms* (Sept. 2005).

⁶³ National Taxpayer Advocate 2004 Annual Report to Congress 401-402 (Key Legislative Recommendation – Small Business Burdens). Congress enacted this proposal May 25, 2007. See U.S. Troop Readiness, Veterans’ Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007, Pub. L. No. 110-28, § 8215(a), 121 Stat. 193 (2007).

⁶⁴ National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem #1 – Alternative Minimum Tax for Individuals), National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Key Legislative Recommendation – Alternative Minimum Tax).

⁶⁵ National Taxpayer Advocate 2006 Annual Report to Congress 470-482 (Key Legislative Recommendation – Eliminate (or Simplify) Phase-outs).

⁶⁶ National Taxpayer Advocate 2004 Annual Report to Congress 390-393, and National Taxpayer Advocate 2002 Annual Report to Congress 246.

⁶⁷ See Alan H. Plumley, IRS Pub. 1916, *The Determinants of Individual Income Tax Compliance: Estimating The Impacts of Tax Policy, Enforcement, and IRS Responsiveness* 35-36 (Nov. 1996).

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- If the impact of audits varies by the type of audit and by industries, what does this mean for IRS enforcement policy?
- Are “soft notices” effective at improving voluntary compliance in certain situations, thereby reducing the need for more costly audits?⁶⁸

The IRS should study the impact of audits in the cash economy to help determine whether the recent increase in the small business examination rate is likely to affect the tax gap,⁶⁹ or whether an entirely new approach is warranted.

Increasing the Focus on Preparers

Return preparers play a key role in our tax system. Paid preparers handled 61 percent of all tax returns and 73 percent of sole proprietor returns in 2006.⁷⁰ Research suggests preparers can significantly influence the compliance behavior of small businesses.⁷¹ The IRS needs more research, however, to determine the degree to which preparers impact the underreporting of gross receipts and the overstatement of expenses.⁷²

Especially if research shows that preparers do significantly impact taxpayer compliance, the IRS should consider new approaches to help ensure that preparers diligently promote tax compliance among their clients. Because a return preparer may have multiple small business clients, the ability to identify preparers who understate gross receipts or inflate expenses would leverage the IRS’s limited enforcement resources. One approach is to combine the TAS proposal to regulate preparers⁷³ with new initiatives to identify potentially problematic preparers.

Hairdressers and cab drivers must be licensed before they perform their services, but there is no such requirement for tax preparers. The National Taxpayer Advocate has proposed in the past that preparers be regulated so that taxpayers have assurance that the person preparing their tax return has some minimum level of qualifications.⁷⁴

The IRS should investigate creating a preparer database that would allow enforcement personnel to identify potentially problematic preparers. By organizing summary tax return information on clients and preparer characteristics, the database would allow IRS research-

⁶⁸ “Soft notices” are informational or educational notices.

⁶⁹ The examination rate for non-farm business returns was 3.1 percent in FY 2006, up from 2.1 percent in FY 2004, and 1.7 percent in FY 2002. IRS, *2006 Data Book*, Pub. 55B, Table 9 (Mar. 2007), *2004 Data Book*, Pub. 55B, Table 10 (Mar. 2005), *2002 Data Book*, Pub. 55B, Table 9 (Nov. 2003).

⁷⁰ IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2005).

⁷¹ A study conducted for the IRS found, “...the taxpayer-preparer relationship is an unusually close business relationship, with the taxpayer trusting and relying on preparer advice.” Russell Marketing Research, *Findings from One-On-One efile Research Among Taxpayers and Preparers*, Pub. 4350 (June 2004). When taxpayers were asked for their perception of their preparer, 97 percent said the preparer was extremely or very experienced and knowledgeable, and 98 percent said they trusted their preparer completely or very much. *Id.* The study was targeted at taxpayers who were offered electronic filing but declined. However, the authors note that this finding provides insight into the taxpayer-preparer relationship for all taxpayers.

⁷² See Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*, *infra*.

⁷³ National Taxpayer Advocate 2006 Annual Report to Congress 197-221.

⁷⁴ See National Taxpayer Advocate 2006 Annual Report to Congress 197-221.

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ers to study voluntary compliance at the preparer level. Examples of the type of questions that could be explored include how many of the preparer's returns:

- Contain a math error;
- Have compliance risk scoring outside expected parameters;⁷⁵
- Have had an audit and tax change; or
- Include a condition that has historically led to compliance issues.⁷⁶

The IRS could thus create a compliance risk score that would identify preparers who may be permitting or actively fostering noncompliance. Such a risk score will need thorough review to ensure that compliant preparers are not falsely targeted.

In many cases a “soft touch” such as soft notices⁷⁷ or outreach might be sufficient to redress compliance issues.⁷⁸ The National Taxpayer Advocate recommends that the IRS conduct a test of soft notices to determine their effectiveness in improving compliance. The IRS should also initiate audits where merited, *i.e.*, when preparers are non-responsive.⁷⁹

Conducting Research on Attitudes toward Tax Compliance

The IRS should consider establishing a research unit devoted to exploring the effect taxpayer attitudes have on voluntary compliance and finding ways to positively influence those attitudes. Existing research suggests a taxpayer's willingness to pay taxes voluntarily is not based exclusively on risk (“how likely am I to get caught if I cheat on my taxes?”) but is also influenced by personal values and social norms.⁸⁰ Understanding these attitudes can help the IRS determine what types of education and outreach will maintain and increase voluntary compliance.

For example, it may be appropriate to conduct an education campaign among cash economy taxpayers emphasizing how tax revenues fund popular federal programs, including those that benefit the particular business sector. For taxpayers who have emigrated from a

⁷⁵ IRS computers assign a score to returns which indicates the potential for inaccurate information on the return. The algorithms are developed based on past experience with similar returns.

⁷⁶ The IRS is currently exploring automated means for identifying potential issues on tax returns. See IRS Small Business/Self-Employed Division Research – Seattle/San Jose, Project SEA0016, *Blaze Advisor Proof of Concept*, April 7, 2006.

⁷⁷ “Soft notices” are informational or educational notices. In this situation, the notice might inform the preparer that the IRS has noticed a pattern in the preparer's returns that is often an indication of inaccurate reporting. Ideally the notice would identify specific issues that appear to be problematic. The notice could then explain the responsibilities of preparers and the possible penalties if it is determined a preparer is submitting inaccurate returns.

⁷⁸ The effectiveness of a soft notice approach will depend on how the preparers react. Do notices describing concerns about a preparers' returns result in improved compliance similar to what we expect from audits? Do audits on a couple of clients result in the preparers changing behavior on all clients?

⁷⁹ The IRS Small Business/Self-Employed division and the Office of Professional Responsibility co-sponsored a “Return Preparer Summit” in September 2007, with the goal of creating a servicewide preparer strategy. IRS expects the strategy and supporting action plan to be released in March 2008.

⁸⁰ Margorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers, infra* (recommending the IRS implement long and short term educational and media programs to encourage voluntary compliance that incorporate the findings of behavioral research)..

country where there was wide mistrust of the government, an education campaign might emphasize the integrity of the tax system, taxpayer rights, and privacy laws.

Improving Payment Compliance

The IRS estimates the portion of the tax gap attributable to underpaying tax to be \$33 billion, or about ten percent of the gross tax gap.⁸¹ Some of this deficit is due to taxpayers intentionally avoiding their tax obligations, which traditional enforcement approaches such as liens and levies can address. However, the IRS should use other approaches to assist taxpayers who are trying to meet their obligations.

Making Payment Compliance Easier

It is possible that the underpayment component of the tax gap may grow if the IRS is successful in closing the underreporting portion of the tax gap. The National Taxpayer Advocate believes it is critical that the IRS make payment compliance easier and more effective in the future.

Encourage More Frequent Estimated Payments Through EFTPS

Self-employed individuals are required to make quarterly estimated tax payments to the IRS and are subject to a penalty for failing to make these payments by April 15, June 15, September 15, and January 15.⁸² These due dates fall at irregular intervals ranging from two to four months and may result in payments being late.

One payment option available to taxpayers is the Electronic Federal Tax Payment System (EFTPS) which allows users to schedule electronic payments up to six months in advance for businesses and one year in advance for individuals, as frequently as the user wishes. The IRS should encourage taxpayers to schedule weekly or monthly payments to avoid the trouble of saving money to make lump sum payments, and to avoid penalties.

The IRS should also consider abating an estimated tax late payment penalty as an incentive for taxpayers to use EFTPS. In 2004, the IRS offered to abate one late filing penalty on missed Federal Tax Deposit (FTD) payments to encourage employers to enroll in and use EFTPS.⁸³ Extending this incentive to taxpayers making estimated tax payments will further increase usage of EFTPS.⁸⁴

⁸¹ IRS, *National Research Program*, Tax Year 2001.

⁸² IRC § 6654(c)(2).

⁸³ IRS News Release, *IRS Offers Penalty Refund for EFTPS Enrollment* (May 24, 2004). The IRS discontinued the abatement at the end of 2006. Businesses receiving a penalty for a late FTD for any quarter after January 1, 2007 are no longer eligible for an FTD penalty refund. IRS Headliner Volume 184, *IRS To End EFTPS FTD Penalty Refund Offer* (Nov. 9, 2006). Federal Tax Deposits are the income and employment taxes withheld by employers and submitted to the IRS.

⁸⁴ See Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy*, vol. 1, *supra* (requesting Congress to establish a goal of collecting at least 75 percent of all estimated taxes electronically by fiscal year 2014). The National Taxpayer Advocate made similar proposals in 2005. See National Taxpayer Advocate 2005 Annual Report to Congress 55, 64-65 (Most Serious Problem – The Cash Economy), 381, 389-391 (Key Legislative Recommendation – Measures to Reduce Noncompliance in the Cash Economy).

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Send Reminder Notices to Taxpayers for Estimated Payments

For small business taxpayers not enrolled in EFTPS, the irregularly-spaced dates for estimated tax payments (see above) increase the likelihood the taxpayer will miss a deadline. The IRS should consider sending reminder notices to taxpayers who have missed payments in the past. These notices are also a prime opportunity to encourage taxpayers to enroll in the system and schedule monthly or weekly payments.⁸⁵

Allow Voluntary Withholding Agreements between Independent Contractors and Service Recipients

As discussed earlier in this strategy, voluntary compliance is highest where there is both information reporting and withholding. Some independent contractors may wish to have a withholding agreement with one or more payors to avoid making estimated tax payments. However, it is unclear whether statutory authority exists to enter into such agreements.⁸⁶

Congress should amend IRC § 3402(p)(3) to specifically allow voluntary reporting agreements between independent contractors and service recipients (as defined in IRC § 6041A(a)(1)).⁸⁷

Using Collection Alternatives

For taxpayers who lack the financial means to pay the taxes they owe, traditional enforcement approaches are not effective in the long run. Collection alternatives, such as partial payment installment agreements and improved access to the offer in compromise program, should be available to taxpayers who can pay some but not all of their liabilities.⁸⁸ Otherwise, the IRS risks pushing these taxpayers into perpetual noncompliance.⁸⁹

If the proposals in this strategy effectively identify underreporting, many taxpayers may face assessments they cannot pay. As in all situations where a taxpayer is unable to pay the full amount due, the IRS should consider collection alternatives that allow the taxpayer to quickly return to the tax system.

Exploring and implementing approaches that help resolve accounts earlier in the collection process will also make it easier for taxpayers to become compliant.⁹⁰ For example, some

⁸⁵ Both GAO and TIGTA previously recommended that the IRS test a soft notice program to improve estimated tax payment compliance. See General Accounting Office, GAO/IGD-99-18, *Billions in Self-Employment Tax Are Owed* 8 (Feb. 1999) and Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004) (recommending that IRS implement a soft notice for estimated tax payments and noting that although IRS planned to implement GAO's soft notice recommendation, it delayed and then canceled the planned implementation).

⁸⁶ For a detailed description of this issue, see National Taxpayer Advocate 2005 Annual Report to Congress 391-394.

⁸⁷ Changes to the Code should specify that independent contractors who enter into voluntary agreements with payor service recipients will be treated as employees only to the extent specified in the agreement, and allow them to continue to deduct ordinary and business expenses under IRC § 162(a). See Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy*, vol. 1, *supra*.

⁸⁸ See Most Serious Problems, *Offer In Compromise, and Status Update; Collection Strategy*, vol. 1, *supra*.

⁸⁹ See Most Serious Problem, *Offer In Compromise, supra*.

⁹⁰ See National Taxpayer Advocate 2006 Annual Report to Congress 62-82.

taxpayers do not respond to IRS notices but might respond to other approaches. The IRS should consider conducting research to identify taxpayers who likely will not respond during the notice process and why they will not respond, and should investigate alternative treatments.

Other approaches may be needed to encourage taxpayers to come back into the system, such as:

- Encouraging states (through partnerships) to require taxpayers to certify tax compliance to obtain or retain business licenses;
- Requiring backup withholding for independent contractors with a history of noncompliance;⁹¹
- Waiving backup withholding once taxpayers demonstrate they have become compliant and agree to schedule and make future payments through EFTPS;⁹² and
- Requiring federal contractors to demonstrate tax compliance.

Improving Filing Compliance

The IRS estimates the tax gap attributable to failure to file tax returns to be at least \$27 billion, or about eight percent of the gross gap.⁹³ Reducing nonfiling is critical to reducing the gap in the long term because taxpayers must first be in the tax system before the IRS can address other compliance issues.

Unlike underreporting estimates which are based on audit results and underpayment estimates which are based on actual payment behavior, the IRS has less hard data on which to estimate the nonfiling tax gap. Current enforcement efforts to identify nonfilers, such as the Automated Substitute for Return (ASFR) program, rely heavily on third party information reporting and are limited in their reach.

Making Filing Compliance Easier

Educate Taxpayers about Filing Requirements

Table 1 presented earlier in this strategy projected a significant increase in the number of taxpayers served by SB/SE. Other IRS research notes the following trends:⁹⁴

- U.S. Internet retail sales are expected to grow to \$316 billion by 2010 at an annual rate of 14 percent;
- About one in six baby boomers plans to start his or her own business in retirement;

⁹¹ See Key Legislative Recommendation, *Measures to Address Noncompliance in the Cash Economy* Vol. I, *supra.* and National Taxpayer Advocate 2005 Annual Report to Congress 383-389.

⁹² *Id.*

⁹³ IRS, *National Research Program*, Tax Year 2001.

⁹⁴ Wage and Investment Research, Project 7-04-16-3-004N, *A Profile of W&I and SBSE 1040 Tax Returns for Tax Year 2001 and Trends in Self-Employment* (2004).

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- Immigrants are more likely to be self-employed than U.S.-born citizens;
- The number of one-person businesses grew twice as fast between 1997 and 2002 as the number of companies with paid employees; and
- Employer buy-out offers are growing, with the former employee sometimes hired back as a contractor.

All of these trends represent opportunities to educate taxpayers on their filing requirements. The IRS should use all available research on small business trends to formulate and target its education and outreach efforts.⁹⁵ The SB/SE CLD organization should ensure that its activities address these trends and the particular needs of taxpayers in the cash economy.⁹⁶

New entrepreneurs may be unaware of the tax implications of being self-employed and the corresponding filing obligations. Self-employed immigrants present a particular challenge. Issues affecting compliance include language barriers and cultural attitudes toward taxes.⁹⁷ Where citizenship may be an issue, immigrants who wish to pay their taxes may fear that the IRS will share data with immigration authorities.⁹⁸

Additional Research on Nonfilers

Many of the tools that identify the underreporting of gross receipts can also be used to identify nonfilers. Evidence of income or cash expenditures, along with better use of data matching with state revenue agencies, carries enormous potential for identifying taxpayers who fail to file.

Success in improving reporting compliance will involve more than simply increasing computer matching techniques. Through careful research, the IRS should develop algorithms that increase the likelihood that potential nonfilers do in fact have a filing requirement.⁹⁹ Other research questions the IRS could pursue include:

- Have the characteristics of nonfilers changed in recent years?¹⁰⁰

⁹⁵ Additional research may be needed to determine when to target education messages during the business life cycle. For example, should business owners receive tax information about employees when the business is first formed or when the first employee is hired? Is repetition more effective than the timeliness of the message?

⁹⁶ SB/SE convened a task force to develop recommendations for enhancing outreach and education to small business taxpayers. In September 2007, the task force provided nine recommendations which included developing a five-year strategic plan for delivering outreach and education, developing a campaign to educate first-time Schedule C filers, reducing cultural and language barriers to tax compliance, and continuing research efforts to better understand small business taxpayers.

⁹⁷ National Taxpayer Advocate 2006 Annual Report to Congress, 333-354 (Most Serious Problem – Limited English Proficient Taxpayers: Language and Cultural Barriers to Tax Compliance).

⁹⁸ Disclosure of federal tax data to Immigration and Customs Enforcement for nontax violations of civil law is generally not allowed under IRC § 6103. For additional information see IRS, *Disclosure Litigation and Reference Book*, available at <http://www.irs.gov/pub/irs-utl/dlrbook.pdf>.

⁹⁹ IRS Research found that only one of four taxpayers who was sent a notice for failure to file was in fact liable for filing a return. Small Business/Self-Employed Research – Fort Lauderdale/Greensboro, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers* (Jan. 2006).

¹⁰⁰ For example, the aging of baby boomers means there will be an increasing number of older self-employed taxpayers.

- What IRS enforcement actions or services are best at restoring compliant behavior over time? For example, past research has shown that some taxpayers become nonfilers when faced with a tax debt they cannot afford to pay.¹⁰¹ Which IRS responses are most associated with taxpayers becoming compliant and staying compliant – offers in compromise, installment agreements, or abating interest and penalties?
- To maximize the coverage of tax gap issues, should the IRS devote more resources to identifying and pursuing nonfilers? In other words, where should the IRS spend its next dollar to have the biggest impact in reducing the cash economy tax gap?

Conclusion

The tax gap recently has received more congressional and public attention than any other issue in tax administration — and that’s appropriate. In 2001, the most recent year for which estimates are available, the net tax gap stood at \$290 billion.

The largest single component of the tax gap is the cash economy. Where wages are subject to withholding or payments are subject to third-party information reporting, compliance is very high. Where there is no reporting or minimal reporting to the IRS, compliance rates plummet.

The seemingly easy answer is to require that all payments be reported to the IRS or that the IRS should move aggressively against persons who receive payments that are not reported to the IRS. In reality, however, there are no easy answers. Broadly expanding withholding or third-party information reporting will clearly close the tax gap, but will also impose significant burden on third-party payors, even where there is no compliance problem currently.

Moving aggressively against persons who receive payments that are not reported to the IRS could improve compliance rates, but the IRS does not necessarily know who receives cash payments (if it did, the problem wouldn’t exist). Moving “aggressively” carries with it an assumption that taxpayers are intentionally under-reporting their income. In many cases, noncompliant taxpayers are not deliberately “cheating,” but are unable or unwilling to comply with extensive tax filing and reporting rules. We must ensure that the rush to collect more revenue does not trample basic taxpayer rights.

At present, we are concerned that the IRS is addressing elements of cash economy transactions in discrete pieces. To balance the competing concerns described above, we recommend that the IRS create a Cash Economy Program Office to think through these issues and develop a comprehensive, coordinated approach.

¹⁰¹ Small Business/Self-Employed Research Division – Fort Lauderdale/Greensboro, Project 04.01.014.06, *Literature Review and Preliminary Recommendations on Measuring the Impact of Outreach on Non-filers 10* (Jan. 2006).

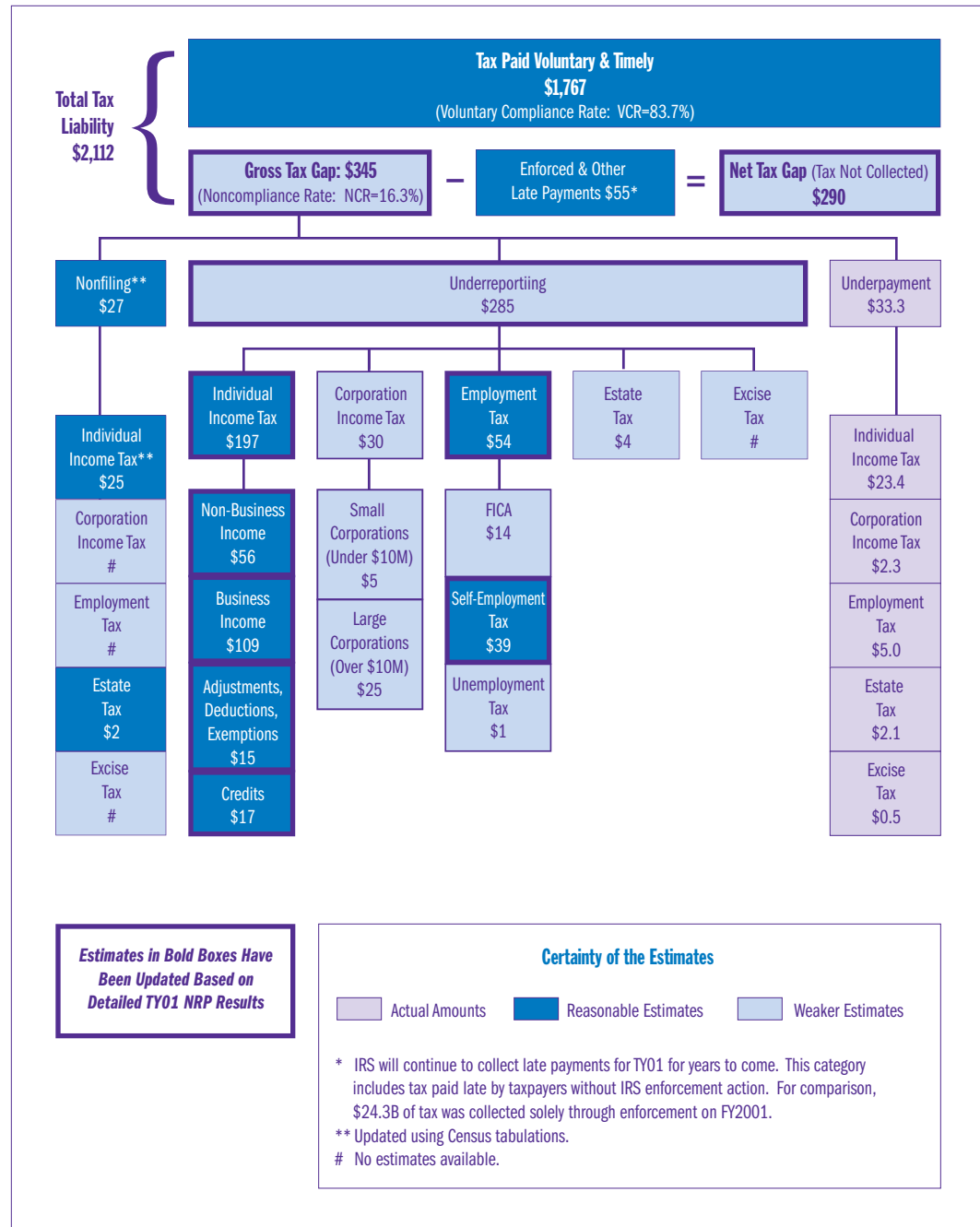
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Among other steps, the IRS should update its procedures wherever possible to make compliance easier for taxpayers and should provide the services and outreach needed by taxpayers who are doing their best to comprehend and meet their tax obligations. The IRS should also implement new techniques for identifying and addressing noncompliance and conduct the research necessary for choosing and targeting enforcement actions while minimizing burden to the greatest extent possible and protecting taxpayer rights.

In addition, we recommend that Congress act to simplify the myriad tax requirements affecting small businesses and, where appropriate, require increased information reporting. Together, these actions should go a long way toward reducing the tax gap without imposing unreasonable burdens on taxpayers.

Appendix A – Tax Gap Map

Tax Gap Map for Tax Year 2001 (in \$ Billions)



Internal Revenue Service, Feb. 2007

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STUDY OF THE ROLE OF PREPARERS IN RELATION TO TAXPAYER COMPLIANCE WITH INTERNAL REVENUE LAWS

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Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws

*Leslie Book**

I. Introduction

The use of paid tax return preparers has grown steadily.¹ Recent estimates indicate that 62 percent of all individuals use some type of paid tax return preparer.² No formal requirements or educational background are needed to either prepare a return or offer advice in connection with the preparation of a tax return, and there are many types of tax return preparers.³ Recent estimates indicate that there are around 1.2 million preparers, many of whom are accountants, attorneys, or enrolled agents (EAs), that is practitioners who are subject to their respective professions' standards for professionalism and conduct.⁴ Other preparers have no connection to formal professions, and are thus not subject to the professional standards for conduct or Treasury Circular 230's potential disciplinary

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¹ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007). From 1996 to 2005, the number of individual income tax returns prepared by paid practitioners increased from 63 million to 80 million. The total number of tax returns prepared by paid preparers rose to 74 percent of total reported taxes. "This trend indicates the growing dependency of our nation's tax system on the tax preparation industry and it underscores the need for the Internal Revenue Service to better understand how commercial tax preparation influences reporting behavior." *Id.*

² Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007).

³ IRC § 7701(a)(36). The Internal Revenue Code defines an income tax return preparer as "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by subtitle A or any claim for refund of tax imposed by subtitle A. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund." *Id.*

⁴ These categories of practitioners are all generally subject to examination, continuing education and ethics requirements. See National Taxpayer Advocate 2002 Annual Report 219-20; AICPA Code of Professional Conduct available at <http://www.aicpa.org/about/code/index.htm> (2006) (giving standards of conduct for all CPAs); ABA Model Rules of Professional Conduct available at http://abanet.org/cpr/mrpc/mrpc_toc.html (giving standards of conduct for all attorneys).

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proceedings for misconduct.⁵ Many of those preparers file fewer than ten tax returns, and it seems likely that a large percentage of those preparers are employed in other activities and are unlikely to have significant experience or exposure to substantive tax law.⁶ All paid return preparers, including those who are not regulated by any licensing entity or subject to competency or continuing education requirements, must comply with certain requirements in connection with the preparation of a tax return, including signing the return⁷ and

⁵ See 31 CFR §§ 10.1-10.93 (2005) (reproduced in Circular 230). Treasury Circular 230 sets forth standards for tax practice and establishes a series of potential disciplinary actions against those practitioners who violate those standards. See Treasury Inspector General for Tax Administration, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners*, No. 2006-10-066 (Mar. 2006). The IRS is aware of approximately 800,000 people who are unenrolled tax preparers. Employees of large national return preparation chains undergo some training and are subject to internal quality reviews. Some of these employees are subject to Treasury Circular 230 due to their status as CPAs, enrolled agents, or attorneys. See Robert Weinberger, *Comments on Treasury/IRS Notice of Proposed Rulemaking Modifying Regulations to Circular 230 Standards of Practice Before the Internal Revenue Service*, 2007 TNT 215-35 (Nov. 6, 2007) (stating that approximately five percent of HR Block's practitioners are "licensed under Circular 230"). Currently, California and Oregon are the only two states requiring enrollment and certification of all tax preparers. See Oregon Board of Tax Practitioners, http://egov.oregon.gov/OTPB/about_us.shtml (last visited Oct. 4, 2007); Certification and Licensing Requirements, http://egov.oregon.gov/OTPB/Certification_and_licensing_requirements.shtml; (California Tax Preparer Code of Conduct, <http://www.ctec.org/index.asp?pid=7> (presenting California's Code of Conduct for Tax Preparers which requires registration for a "person who, for a fee or other consideration, assists with or prepares tax returns"). While the states' requirements and obligations differ in both California and Oregon there is an exception for CPAs who hold a valid license from the State Board of Accountancy and attorneys who are active members of their respective state Bar Associations. In California, there is also an exception for enrolled agents who are enrolled to practice before the IRS. For a summary of the requirements necessary to become an enrolled agent. See Enrolled Agent Information, IRS Website, <http://www.irs.gov/taxpros/agents/article/0,,id=100710,00.html>. There have been legislative proposals to impose federal regulation of return preparers. See e.g., S. 882, The Tax Administration Good Government Act (based on recommendations made by the National Taxpayer Advocate in her 2002 Annual Report to Congress at 216-230).

⁶ National Taxpayer Advocate 2002 Annual Report to Congress 225 (looking at IRS 1999 filing year data).

⁷ IRC § 6695(b) (imposing penalties on tax preparers who do not sign returns). The Temp. Regs. Sec. 1.6695-1T(b) also requires that a return preparer sign each return he or she prepares after completing it and before presenting it to the taxpayer. In Notice 2004-54, the IRS authorizes return preparers to sign original returns, amended returns, and extension requests by rubber stamp, mechanical device or computer software program. These signing methods must include either a facsimile of the preparer's signature or his or her printed name. Return preparers using one of these alternative means are personally responsible for affixing their signatures to returns or extension requests. If they use an alternative signing method, they must provide all of the other preparer information required on returns and extensions, such as (1) name, address and relevant employer identification number (EIN), (2) individual ID number (Social Security number or preparer tax ID number) and (3) telephone number. For an overview of return preparer standards see Terri Guitierrez, *Return Preparer Penalties: A Comprehensive Review*, The CPA Journal; available at <http://www.nysscpa.org/cpajournal/2001/0600/features/f063401.htm>.

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providing a copy of the return to taxpayers.⁸ Preparers are also subject to civil⁹ and even criminal¹⁰ penalties for improper conduct and the Code provides that the United States may bring a civil action to enjoin tax preparers if preparers engage in certain types of impermissible conduct.¹¹

Practitioners of all types can alleviate barriers to compliance, including computational difficulty and legal complexity. They can help ensure that taxpayers take advantage of benefits administered through the tax system, such as the earned income tax credit (EITC), and help the government with its objective of increasing electronic filing.¹² Yet, they also can contribute to taxpayers failing to comply with the internal revenue laws in a number

⁸ IRC § 6107(b) (requiring furnishing copy of tax return to taxpayer).

⁹ A summary of some of the applicable penalties follows:

Code Section (§)	Description	Penalty
6694(a)	Understatement of taxpayer's liability due to an unrealistic position (unrealistic position redefined in 2007)	An amount equal to the greater of: a) \$1,000 or 50% of the income derived (or to be derived)
6694(b)	Understatement of taxpayer's liability due to willful or reckless conduct (willful or reckless conduct redefined in 2007)	An amount equal to the greater of: a) \$5,000 or 50% of the income derived (or to be derived)
6695(a)	Failure to provide a copy of return to taxpayer	\$50 per failure
6695(b)	Failure to sign return	\$50 per failure
6695(c)	Failure to furnish identifying number	\$50 per failure
6695(d)	Failure to retain a copy or list of returns filed	\$50 per failure
6695(e)	Failure of employers to file correct information on each tax preparer employed	\$50 per failure
6695(f)	Negotiation of taxpayer's refund check	\$500 per check
6695(g)	Failure to be diligent in determining earned income tax credit eligibility	\$100 per failure
6701	Aiding and abetting understatement of tax liability	\$1,000
6713	Improper disclosure or use of return information	\$250 per disclosure up to a maximum of \$10,000
7206	Willful preparation of false or fraudulent return or other document	Up to \$100,000, 3 years imprisonment, or both
7207	Knowingly providing fraudulent returns or other documents to IRS	Up to \$10,000, 1 year imprisonment, or both
7216	Knowingly or recklessly disclosing or using return information	Up to \$1,000, 1 year imprisonment, or both
7407	Authority to enjoin income tax preparers*	

* For a summary of the IRS's current civil and criminal legal actions against preparers, see *Tax Return Preparer Fraud*, (Jan. 2007) available at <http://www.irs.gov/newsroom/article/0,,id=167391,00.html>.

¹⁰ See e.g. IRC §§ 7201, 7206, 7207 and 7216. Return preparers can be subject to criminal penalties for fraudulently preparing returns or other documents. The possible deterrent effect of criminal sanctions against preparers is limited by the difficulty associated with establishing the proof of mental state of the preparer, i.e., that the preparer knew the return was false as filed. Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 164 (2002).

¹¹ In April of 2007, Jackson Hewitt franchisees were served injunction suits in four different states. The complaints in the injunction suits can be found at <http://www.usdoj.gov/tax/txdv07215.htm>; *United States v. Smart Tax Inc.*, No. 07C-1802 (N.D. Ill. Apr. 2, 2007); *United States v. Smart Tax of Georgia Inc.*, No. 07CV-0747 (N.D. Ga Apr. 2, 2007); *United States v. Smart Tax of North Carolina*, No. 5:07-cv-00125-FL (E.D. N.C. Apr. 2, 2007); *United States v. So Far Inc.*, No. 2:07-cv-11470 (E.D. Mich. Apr. 2, 2007). The cases were recently settled. See Department of Justice, *Corporations That Owned Jackson Hewitt Franchises in Three States Agree to Be Barred From Tax Return Preparation*, (September 28, 2007), www.usdoj.gov/opa/pr/2007/September/07_tax_779.html.

¹² See U.S. Gov't Accountability Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, But Oversight For IRS is a Challenge* 7-8, GAO-04-70 (2003); Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 15 (2006). Electronic filing significantly reduces IRS processing costs. See U.S. Gov't Accountability Office, *Most Filing Season Services Continue to Improve, But Opportunities Exist for Additional Savings* 7, GAO-07-27 (2006).

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of ways, including actively facilitating taxpayer intentional misconduct, failing to apply the law to a client's circumstances, misunderstanding the law (including overstating a taxpayer's liability), or failing to obtain relevant facts from clients.

As discussed in this article, the research to date regarding how paid preparers affect tax compliance is inconclusive. Some research suggests that practitioners can use their expertise to exploit legal ambiguities.¹³ Research also suggests that practitioners in effect play a dual role; that is they serve to exploit ambiguity, but also tend to serve as enforcers of the law when the law is relatively clear.¹⁴ Reflecting, in part, this research, policymakers and academics alike have emphasized practitioners' role in noncompliance when there is the opportunity to take advantage of legally ambiguous issues. For example, in *Markets in Vice Markets in Virtue*, interviewing advisors in New York and Australia, John Braithwaite studied the rapid growth in tax shelters in the late 20th century. Braithwaite's study emphasized the role that tax advisors have played in the growth of tax shelters, and noted the contagion effect that supply-driven shelter advice can have on taxpayer norms¹⁵ and expectations.¹⁶ Likewise, in proposing solutions to compliance problems, many commentators have emphasized the practitioners' role in connection with positions characterized by legal ambiguity.¹⁷

Much of the compliance literature and a great deal of governmental efforts directed at return preparers are aimed at tempering practitioner's appetites for exploiting ambiguity. For example, Eric Toder notes that much of "the popular perception of the tax gap comes from articles and books that publicize how corporations and wealthy individual taxpayers use highly-paid tax lawyers and accountants to devise sophisticated schemes to reduce their tax liability to a small fraction of their economic income."¹⁸ Notwithstanding the importance of understanding and reducing the gap that is associated with practitioners' role in exploiting ambiguities, a significant amount of the tax gap relates to items that are not characterized by legal ambiguities. The tax gap data shows that a large portion of the underpayment rate relates to issues where there is not the same opportunity for creative tax advice to

¹³ See Steven Klepper, Mark Mazur and Daniel Nagin, *Expert Intermediaries and Legal Compliance: The case of tax preparers*, 34 *Journal of Law and Economics* 205 (1991).

¹⁴ See *Id.*

¹⁵ For further discussion of tax norms in areas where advisors can exploit ambiguity or take advantage of literal interpretations to achieve large tax benefits, see Alex Raskolnikov, *The Cost of Norms: The Tax Effects of Tacit Understandings*, 74 *U. Chi. L. Rev.* 601 (2007) (discussing, for example, the hedging strategy of variable delivery prepaid forward contracts) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=939174. Raskolnikov has also discussed the manner in which the penalty regime might better influence advisors and taxpayers, especially in areas of legal complexity and ambiguity. Alex Raskolnikov, *Crime and Punishment in Taxation*, 106 *Colum. L. Rev.* 569 (2006).

¹⁶ John Braithwaite, *MARKETS IN VICE MARKETS IN VIRTUE* (Oxford Univ. Press 2005) (2005).

¹⁷ See e.g. Linda Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 *Va. Tax Rev.* 583, 587 (2006).

¹⁸ Eric Toder, *What is the Tax Gap?*, 117 *Tax Notes* 367 (Oct. 22 2007).

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exploit ambiguities through engineering artificial losses or deferring the receipt of income.¹⁹ Changing the penalty regime to impose greater requirements of legal certainty on positions²⁰ or changing Treasury Circular 230 requirements to encourage practitioners to temper aggressive tax reporting positions will not have much effect when the noncompliance does not relate to aggressive interpretations of the law, but rather relates to, for example, relatively unambiguous legal matters dependent on the accurate presentation of essential facts and practitioner understanding of complex but fairly unambiguous legal rules.

Recent tax gap data suggests that this duality approach is not nuanced enough to capture the true dynamics between taxpayers and practitioners, especially when one views the significant tax gap figures associated with relatively unambiguous areas of the law. The gross tax gap is the shortfall after the true tax liability has been paid voluntarily and on time, and the net tax gap is the shortfall less the amount paid late or collected through enforcement activities or through voluntary payments made after the original due date.²¹ Both gross and net tax gaps can be subdivided into three main components: the non-filing gap, the underreporting gap, and the underpayment gap.²² The underreporting aspect of the tax gap itself is divided into three elements: underreported income, overstated offsets, and net arithmetical mistakes.²³ The 2001 estimate of the underreporting tax gap amounts to approximately \$285 billion,²⁴ and the individual income tax amounts to about 69 percent of the gross underreporting tax gap. Of that portion of the gross tax gap, the underreporting of business income is by far the most significant, with 2001 estimates suggesting that sole-proprietor

¹⁹ See *Id.* (“Sophisticated avoidance techniques may be thought of as coming in two general forms. The first involves the use of devices to hide income or transactions that if detected would clearly trigger increased tax liability... [The] “second set of transactions straddle the boundary between tax avoidance (legal) and tax evasion (illegal). Often these consist of a series of separate transactions, all of them within the letter of the tax law, that reduces tax liability, but produce no expectation for pretax economic gain.”). The literature surrounding the rise in tax shelters is voluminous. See also Sagit Leviner, *A New Era of Tax Enforcement: From Big Stick to Responsive Regulation*, University of Michigan John M. Olin Center for Law & Economics 1 (Updated Feb. 2007). See e.g. Linda Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 Va. Tax Rev. 583, 587 (2006).

²⁰ Joint Committee on Taxation, Technical Explanation of the “Small Business And Work Opportunity Tax Act Of 2007” And Pension Related Provisions Contained in H.R. 2206 as Considered by the House of Representatives on May 24, 2007, JCX-29-07 (May 2007). For example, the Small Business and Work Opportunity Tax Act (SBWOTA) broadens the definition of tax return preparer to also include persons preparing estate and gift tax returns, excise tax returns, and employment tax returns; previously the definition centered on income tax return preparers. I.R.C. § 6694, PL 110-113. For tax return preparers, SBWOTA also replaces the realistic possibility standard for undisclosed positions with the requirement that there be a reasonable belief that the tax treatment was more likely than not the proper treatment. The non-frivolous standard is also replaced by the requirement that there be a reasonable basis for the tax treatment when accompanied by a disclosure. SBWOTA also increases penalties for the undisclosed positions as well as for willful or reckless positions. For a scathing criticism of these changes see Richard Lipton, *What Hath Congress Wrought? Amended Section 6694 Will Cause Problems for Everyone*, 107 Journal of Tax (forthcoming 2007) (noting the challenges that practitioner face in determining whether a position is more likely than not correct).

²¹ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 367 (Oct. 22, 2007).

²² James et al., *Role of Tax Agencies in Influencing Taxpayer Compliance*, 5th Int’l Conference on Tax Admin 168 (2004). For a discussion and summary of the 2001 tax gap estimates, see IRS, *Reducing the Federal Tax Gap* (Aug. 7, 2007). The IRS’s 2001 estimates are as follows: the gross tax gap is at \$345 billion, and the net tax gap (that is payments that come in late, either through voluntary payments or enforced collection) is \$290 billion.

²³ James et al., *Role of Tax Agencies in Influencing Taxpayer Compliance*, 5th Int’l Conference on Tax Admin 168 (2004) The above definitions suggest a certainty, which may not exist depending on the questions of interpretation regarding the tax law. Often, tax compliance literature considers this from the perspective of what the state assumes is legally owed by taxpayers, but there are situations where the state and taxpayers do not share the same definition. Marcelo Bergman, *Criminal Law and Tax Compliance in Argentina: Testing the Limits of Deterrence*, 26 International Journal of the Sociology of Law 55-74 (1998).

²⁴ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 369 (Oct. 22, 2007). The underpayment gap is estimated at \$33.5 billion and the non-filing gap is estimated at 27 billion.

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underreporting accounts for an enormous \$68 billion. While not as significant in terms of dollars, the tax gap associated with overstated credits, and the Earned Income Tax Credit (EITC) in particular, is likewise very important for policymakers. The EITC, which has become the nation's largest anti-poverty program, has been in the crosshairs²⁵ repeatedly over its thirty-plus year history as data suggests that close to one-third of the amount claimed is in fact claimed in error.²⁶ This report will focus on the reporting of sole proprietor income and the proper claiming of the EITC, two areas in the individual tax gap characterized by complicated but fairly straightforward rules.²⁷

Both EITC taxpayers and sole proprietors use practitioners to help complete and file their tax returns.²⁸ These returns often are characterized by error.²⁹ Some scholars are taking note of the differences associated with errors on practitioner-prepared returns that arise on issues that are not characterized by legal ambiguity. In a recent paper, authors Tackett, Antenucci, and Wolf³⁰ discussed the impact of client honesty and the role of preparers. The authors perceptively noted that while Circular 230 maintains that practitioners can be subject to sanction if they recommend a client take a position on a tax return that does not have a realistic possibility (a one in three chance) that the position would prevail in court, "there is no probabilistic standard for establishing when preparers should reject client tax data (or a client) because of integrity issues."³¹ The authors also noted that preparers often give their clients the benefit of the doubt regarding the integrity of the data that clients provide, and consider the possibility that many preparers can be "unwitting participants in

²⁵ See Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005) (summarizing the administrative and legal efforts and noting over-weighted efforts at compliance directed at EITC); but see Dennis Ventry, *Welfare by Another Name: How We Can Save EITC*, 114 Tax Notes 955 (2007) (explaining that EITC is on much safer ground and that advocates' overstate the compliance risks to the continued validity of the EITC).

²⁶ For a discussion of the substantive EITC eligibility rules, as well as a discussion of the breakdown of EITC errors, see Leslie Book, *Preventing the Hybrid from Backfiring*, 2006 Wisc. L. Rev. 1103, 1110-14 (2006).

²⁷ This is not to say that there is no complexity associated with the proper reporting of sole proprietor income or claiming the EITC. For example, in the recent legislative changes providing for uniform definition of claiming of qualifying child, there are significant ambiguities that likely perplex informed and conscientious return preparers. See Tom Daley, *Unintelligent Design*, 111 Tax Notes 813 (May 15, 2006). Nonetheless, while there are grey areas (e.g., the distinction between expenses that must be capitalized and those that can be deducted), the underreporting in these areas is largely related to the treatment of items not steeped in ambiguity or legal uncertainty. C.f. Joseph Bankman, *The Story of Indopco: What Went Wrong in the Capitalization v Deduction Debate*, TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES (Paul Caron, ed. 2003).

²⁸ Data on the use of commercial preparers among EITC claimants is found in Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, The Crisis in Tax Administration 148, 178-79 (Henry J. Aaron & Joel Slemrod eds., 2004). Researchers have likewise shown that sole proprietors are increasingly using paid preparers. Charles Christian, Sanjay Gupta, & Suming, 46 National Tax Journal 487-504 (1993).

²⁹ See Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 Wis. L. Rev. 1103 (2006). "Recent studies indicate that a significant amount of EITC overclaims are associated with returns which commercial practitioners prepare. Of the approximately \$11 billion in upper-range estimated erroneous EITC claims made in 1999, approximately 57 percent of the overclaims were attributable to returns prepared by commercial return preparers." *Id.*

³⁰ James Tackett, Joe Antenucci, and Fran Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sept. 10, 2007).

³¹ James Tackett, Joe Antenucci, and Fran Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sep. 10, 2007). Note that with the SBWOTA changes discussed above, the standard for sanction has changed, and the IRS will likely modify Treasury Circular 230 to reflect these changes. See Proposed Treas. Circ. 10.34(a).

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the filing of falsified tax returns.”³² At the same time, the authors acknowledge that some unscrupulous preparers are not just duped, but are active participants in the misstating of information on tax returns.³³

Analogizing return preparers to auditors, who because of Sarbanes-Oxley³⁴ have been charged with a greater responsibility in ensuring integrity of the financial data associated with public companies, Taxett, Antenucci, and Wolf suggest that Congress may up the ante on preparers, and expect them to play a stronger role in taxpayer compliance.³⁵ While no perfect fit exists in the preparer/auditor analogy,³⁶ Taxett, Antenucci, and Wolf are on the right track with their exhortation that Congress and others consider that preparers may be in a position to ensure that clients behave better when it comes to more accurately reporting their tax liabilities.

This report will review the literature relating to the practitioners’ influence on tax compliance. Rather than identify practitioners as exploiters or enforcers, this report will examine from a ground-up perspective the underlying causes of errors associated with two systemic issues that have had widely reported and studied noncompliance problems: the reporting of sole proprietors’ income and the claiming of the earned income tax credit. Drawing on a wide range of sources, including existing third-party empirical, behavioral, and theoretical research, IRS studies, and my own experiences as a director of a Low Income Taxpayer Clinic (LITC), this report will consider in a more nuanced manner a typology of the practitioners’ role in sole proprietor and EITC noncompliance. In a subsequent report, I will

³² James Tackett, Joe Antenucci, and Fran Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sep. 10, 2007). Due diligence is required under Circular 230 when practitioners are (1) preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters; (2) determining the correctness of oral or written representations made by the practitioner to the Department of Treasury; and (3) determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS. 31 CFR §§ 10.22 (2005). For CPAs, the Statement on Standards for Tax Services (STS) sets forth the role of the return preparer in relation to verifying facts essential for the completion of a tax return. STS No. 3 emphasizes that the ultimate responsibility for the accuracy of the return lies with the taxpayer, and that a return preparer “may in good faith rely, without verification, on information furnished by the taxpayer or by third parties.” In addition, STS No. 3 clarifies that the preparer does not generally have a duty to examine or verify supporting data; however, the standards also state that the preparer “should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to a member.” Statement on Standards for Tax Services No. 3, Certain Procedural Aspects of Preparing Returns; available at <http://ftp.aicpa.org/public/download/members/div/tax/ssts2.pdf>. Return preparers are subject to specific due diligence rules in connection to the preparing of tax returns in which an individual is claiming the EITC. The role of strengthening preparers’ due diligence requirements in connection with a broader discussion of self-regulation and enforced self-regulation will be discussed in upcoming research connected with this project.

³³ See James Tackett, Joe Antenucci, and Fran Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sept. 10, 2007).

³⁴ Pub. L. No. 107-204, 116 Stat. 745, 107th Congress – 2nd Session (2002). For a more general description of Sarbanes-Oxley legislation and its effect on lawyers and those practicing before the SEC, see Susan Saab Fortney, *National Symposium on the Role of a Corporate Lawyer: The Anticipated and Actual Effect of Sarbanes-Oxley on Corporate Lawyer’s Conduct*, 33 Cap. U.L. Rev. 61 (2004).

³⁵ James Tackett, Joe Antenucci, and Fran Wolf 116 Tax Notes 953 (Sep. 10, 2007). The authors suggest that return preparers can be better equipped to address errors that are tied to clients furnishing false numerical information through increasing the use of digital analysis, a fraud detection method used by forensic accountants and certified fraud examiners.

³⁶ Unlike in the corporate context, it is very difficult to costlessly rely on the public and class action bar to seek out and punish improper tax return preparers, whereas the gatekeeper function is more readily available when there is publicly available financial data and the mechanism of class action lawsuits can seek out and significantly punish improper auditor conduct. See Stuart Karlinsky, and Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5th Int’l Conference on Tax Admin. n.202 (2002). Cf. Dennis Ventry, *Whistleblowers and Qui Tam for Tax*, Tax Lawyer (forthcoming) (2007) (discussing the recently revamped tax whistleblowing program and suggesting that the tax system can improve on this model by adopting a whistleblowing program modeled on the False Claim Act).

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refine the typology further, postulate a theoretical context for legislative and administrative changes to assist in encouraging practitioners to act in a way that may possibly encourage taxpayers to file correct tax returns, and make specific proposals that policymakers may wish to adopt or study further to test effectiveness.

It is my intention that this report will help inspire discussion for an agenda for additional qualitative and quantitative research that may assist policymakers in designing and implementing proposed solutions that have, at their core, an assumption that practitioners can play an increasing role in creating taxpayer compliance norms, and assisting taxpayers in filing more accurate tax returns.³⁷ In particular, it is my hope that a more complete understanding of the dynamics of noncompliance among practitioner-prepared returns will create opportunities for the IRS to rigorously test proposed solutions, with the additional use of pilot programs and use of control groups and field studies.³⁸

II. The Use of Preparers

Some preparers, such as attorneys, CPAs, and enrolled agents (EAs), have passed entrance examinations and are subject to continuing education requirements, and also subject to licensing requirements and disciplinary proceedings.³⁹ According to the Treasury Inspector

³⁷ Professor Coffee suggests two core elements necessary for increased reliance on gatekeepers to help control the behavior of other actors:

1. The gatekeeper must have significant reputational capital, acquired over many years and many clients, which it pledges to assure accuracy of statements it makes or verifies; and
2. Relative to the principal, the gatekeeper receives a smaller payoff for its role as certifying, approving or verifying information.

See John Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 BU L. Rev. 301 (2004). A problem in the tax law area is that many unenrolled return preparers have no or little reputational capital, and while the payoff individually is small, the preparers themselves make significant profits through mass return preparation. An additional problem with gatekeeper reliance, as Coffee notes, however, is there are also principal/agent problems, when “cowboys” within the agent’s organization risk reputational capital to a degree that the firms would not. See *id.* at 310. This was in part the defense that Jackson Hewitt raised in connection with recent allegations of preparer misconduct at certain of its franchise operations, as it conducted an internal review of its operations and suspended the franchisees named in the civil lawsuits. See *Jackson Hewitt Launches Internal Review of Allegations Against Franchisee*, Jackson Hewitt Tax Services Inc., <http://ir.jacksonhewitt.com/phoenix.zhtml?c=177359&p=irol-newsArticle&ID=982454&highlight=>; *Jackson Hewitt Announce Temporary Suspension of Franchised Businesses Named in U.S. Lawsuits*, Jackson Hewitt Tax Services Inc., [http://ir.jacksonhewitt.com/phoenix.zhtml?c=177359&p=irol-newsArticle&ID=983018&highlight.](http://ir.jacksonhewitt.com/phoenix.zhtml?c=177359&p=irol-newsArticle&ID=983018&highlight=) For a further discussion of the Jackson Hewitt lawsuits, see *infra* note 51.

Governmental efforts that have the goal of changing the behavior of tax return preparers will only be effective if there is a causal connection between return preparer behavior and taxpayer compliance decisions. See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5th Int’l Conference on Tax Admin. n.162 (2002); see also Andrew D. Cuccia, *The Effects of Increased Sanctions on Paid Tax Preparers: Integrating Economic and Psychological Factors*, 16 the Journal of the American Taxation Association 42 (1994). The risk of any compliance strategy focusing on preparers gives rise to the possibility that taxpayers will seek out other preparers not affected by governmental actions, or self-prepare returns and continue to misreport. This risk is especially inherent if the noncompliance relates to issues in which the taxpayers do not feel they need assistance in misreporting, and if there are established taxpayer norms which suggest an acceptance of tax evasion. Nonetheless, this report takes as a starting assumption that at least some preparers do and can play a causal role in client decisions to comply, and that the government can play a stronger role in encouraging practitioners to positively influence taxpayer compliance decisions.

³⁸ See Ian Ayres, SUPER CRUNCHERS, WHY THINKING BY NUMBERS IS THE NEW WAY TO BE SMART *Batnam* 63-69 (2007) (discussing the successful government use of randomized testing and regression analysis to help determine the effectiveness of proposals to reduce various State’s unemployment insurance payments). Ayres emphasizes that intuition and experience alone are insufficient as tools for predictive government and business policies, but notes the essential role that experience can play in helping consider the relevant variables that researchers should test. Ayers, at 124. In a sense, Ayres sets out the case for a deep human understanding of the dynamics of the problem at hand, but argues forcefully that the understanding should form the basis for rigorous statistical analysis, and cautions against “theorizing as an end in itself...” Ayres, at 125.

³⁹ For a summary of the myriad of ways such practitioners are registered, See National Taxpayer Advocate 2003 Annual Report to Congress 270. As mentioned above, two states, California and Oregon require return preparers to register with the state.

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General for Tax Administration (TIGTA), using data from 2005 tax account information, it is estimated that there are 137,928 attorneys, 181,237 CPAs, 25,610 EAs, and 62,397 representatives with multiple Circular 230 designations.⁴⁰ Yet, because anyone, regardless of education or training, can prepare federal income tax returns,⁴¹ the definition of preparer includes unlicensed preparers. Some are self-employed, though preparers can work for a variety of different types of enterprises, including law firms, CPA firms, and large national chains of return preparers such as H& R Block, Jackson Hewitt, and Liberty.⁴²

The preparer's tasks consist of: 1) preparing the actual tax forms; 2) identifying items that may affect the taxpayer's liability; and 3) advising clients on resolving any uncertainty that may exist as to tax consequences of ambiguous items.⁴³ A significant amount of research exists surrounding why taxpayers seek preparers, including: the taxpayer's belief that he or she benefited from using a paid practitioner; the taxpayer did not understand the tax laws; the taxpayer lacked the time and patience to complete the returns on his or her own;⁴⁴ and the taxpayer's fear of audit, or a belief that the use of a preparer minimized audit risks.⁴⁵

In addition to completing and filing tax returns, preparers are often responsible for identifying items that affect tax liability and educating taxpayers about the tax law's application to the particular individual's circumstances. Preparers often, though not always, sell tax-related products or services to individuals seeking to have their returns completed,⁴⁶ especially with respect to the EITC. Preparers are required under internal revenue laws to identify themselves on the tax return, and are subject to due diligence requirements⁴⁷ and civil and

⁴⁰ Treasury Inspector General For Tax Administration, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* 17, Table 4, 2006-10-066 (2006).

⁴¹ For a further discussion of estimates of the number of enrolled preparers see *supra* note 5; See 31 CFR § 10.7(e) (2005).

⁴² The three largest national chain return preparers are H&R Block, Jackson Hewitt, and Liberty. H&R Block is the largest, with Jackson Hewitt second, and Liberty the smallest of the three. H&R Block states that the "U.S. clients served constituted 16.1 percent of an IRS estimate of total individual income tax returns filed as of April 30, 2007, compared to 15.7 percent in 2006 and 15.6 percent in 2005." The IRS estimates that 134.5 million individual income tax returns were prepared in 2005, and thus H&R Block prepared about 20 million of these. See Individual Income Tax Returns, Preliminary Numbers, <http://www.irs.gov/pub/irs-soi/05inplim.pdf>. Jackson Hewitt states, in its annual report, that it prepared 3.65 million individual tax returns in 2007 in the United States. See Jackson Hewitt Ann. Report, http://library.corporate-ir.net/library/17/177/177359/items/257860/JTX_2007AR.pdf (2007), (last visited Oct. 30, 2007). Liberty's Annual Report states that it prepared 1.5 million returns in the United States and Canada in 2007. See Liberty Annual Report, <http://www.libertytax.com/uploadedFiles/Files/2007%20Liberty%20Tax%20Annual%20Report.pdf> (2007).

⁴³ See Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 15 (ed. Sawyer) (2006); Andrew D. Cuccia, *The Effects of Increased Sanctions on Paid Tax Preparers: Integrating Economic and Psychological Factors*, 16 the Journal of the American Taxation Association 42 (1994). The Government Accountability Office, in a broad survey of taxpayers, noted that taxpayers chose to use preparers for a variety of reasons, including a lack of understanding of the laws, lack of time or patience to complete their own returns, and the belief that prepares would help facilitate the receipt of a larger or quicker refund. U.S. Government Accountability Office, *Tax Administration: Most Taxpayers Believe They Benefit From Paid Tax Preparers, But Oversight for IRS is a Challenge* 7-8, GAO-04-70 (2003).

⁴⁴ U.S. Government Accountability Office, *Tax Administration: Most Taxpayers Believe They Benefit From Paid Tax Preparers, But Oversight for IRS is a Challenge* 7-12, GAO-04-70 (2003).

⁴⁵ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 17 (Sawyer ed. 2006).

⁴⁶ See *Tax Return Preparation Options for Taxpayers: Hearing Before the Senate Finance Committee 3-4* (Apr. 4, 2006) (written statement of Nina E. Olson, National Taxpayer Advocate discussing how tax practitioners have become a place for the cross marketing of goods and services).

⁴⁷ I.R.C. § 6061. (discussing signing of returns and other documents). For a further discussion of requirements and related penalties see *supra* note 7.

criminal penalties for inappropriate conduct.⁴⁸ There are specific due diligence requirements that apply to practitioners preparing returns where the taxpayer files for the EITC.⁴⁹

III. Errors

Recent GAO investigations of preparer errors,⁵⁰ widely publicized Department of Justice civil injunction proceedings highlighting franchisees of a national chain return preparer's active facilitation of bogus taxpayer refunds and overstated deductions,⁵¹ and Congressional testimony have focused on the role that preparers play in the tax gap.⁵² There is a growing sense that with the increased use of professional preparers in the tax system, the IRS would be better served to understand their role in taxpayers' decisions to comply with the tax laws.⁵³

For example, the recent Government Accountability Office (GAO) study that focused on the quality of returns prepared by preparers affiliated with national chains highlights the need for additional information to assist policymakers in understanding the dynamics of noncompliance. The GAO study was based upon investigators testing one of two scenarios at 19 outlets of several commercial preparers in a metropolitan area. The GAO study relied upon a mystery shopper approach, whereby GAO staff posed as taxpayers in one of two scenarios. In the first scenario, the staff member posed as a plumber who had most of his income reported, but who also had some side income that was not reflected on Forms W-2. He had enough deductions so that it was advantageous for him to itemize deductions. In the other scenario, the staff member posed as a single mother who worked as a retail sales

⁴⁸ See *supra* note 9. I.R.C. §§ 6694(a)-(b), 6107(a)-(b), 6695(a)-(g), 6713(a), 7407(a), 7201, and 7206(1)-(2).

⁴⁹ I.R.C. § 6695(g) (imposing penalty for failure to comply with due diligence requirements with respect to EITC). Applicable regulations describe these requirements. Reg. § 1.6695-2, and the IRS summarizes these rules at: EITC Resources Online for Tax Professionals: Meeting Due Diligence Requirements available at <http://www.irs.gov/businesses/small/article/0,,id=168366,00.html> (describing due diligence requirements and applicable penalties for failing to meet requirements).

⁵⁰ See generally Government Accountability Office, *Paid Tax Return Preparers: In A Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (2006). This study focused on tax returns prepared by paid tax return practitioners at nineteen different sites. GAO staff posed as taxpayers and had tax returns prepared by practitioners at the different sites. The results demonstrated issues with each of the returns ranging from small misstatements that had no effect on the tax, to large mistakes causing an effect on tax to be paid or the refund to be received.

⁵¹ For a discussion of the civil injunction proceedings, see David Ranni, *Jackson Hewitt Owners Deny Wrongdoing*, News & Observer (May 18, 2007), <http://newsobserver.com/business/v-print/story/575475.html>; *Jackson Hewitt Mess Hurts All Franchisees*. (Apr. 4, 2007), <http://www.franchisepick.com/jackson-hewitt-franchise-mess-hurts-all-franchisees>. The complaints in the injunction suits can be found at <http://www.usdoj.gov/tax/txdv07215.htm>; *United States v. Smart Tax Inc.*, No. 07C-1802 (N.D. Ill. Apr. 2, 2007); *United States v. Smart Tax of Georgia Inc.*, No. 07CV-0747 (N.D. Ga Apr. 2, 2007); *United States v. Smart Tax of North Carolina*, No. 5:07-cv-00125-FL (E.D. N.C. Apr. 2, 2007); *United States v. So Far Inc.*, No. 2:07-cv-11470 (E.D. Mich. Apr. 2, 2007). The cases were recently settled. The cases have been resolved. See Department of Justice, *Corporations That Owned Jackson Hewitt Franchises in Three States Agree to Be Barred From Tax Return Preparation*, (Sept. 28, 2007), www.usdoj.gov/opa/pr/2007/September/07_tax_779.html.

⁵² See GAO 2007 *Tax Filing Season Interim Results and Updates of Previous Assessments of Paid Preparers and IRS Modernization and Compliance Research Efforts: Hearing Before Sen. Fin. Comm.* 110th Cong. 2 (2007) (statement of James R. White, Dir. Strategic Issues and statement of David A. Powner, Dir. Information Technology Management Issues); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement submitted by AICPA); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Mark Everson, Commissioner of IRS); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Michael R. Phillips, Deputy Inspector Gen. for Audit Treasury Inspector Gen. for Tax Admin.).

⁵³ See Government Accountability Office, *Interim Results and Updates of Previous Assessments of Paid Preparers And IRS's Modernization and Compliance Research Efforts* 4-5, GAO-07-720T (2007) (noting GAO mystery study and commenting on the importance of research relative to the tax gap).

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clerk, but who also had income from babysitting. She had one child who lived with her, and one who did not.

The study found major errors, especially with respect to the EITC and the reporting of side income. In the GAO study the preparers did not report side income in ten of 19 cases, and the preparers did not ask about where a child lived or ignored answers to the question, and claimed an ineligible child for the EITC in five out of the ten applicable cases.⁵⁴ In cases where side income was an issue, preparers gave the mystery shoppers a variety of advice. Several mystery shoppers were informed that “such income was the decision of the taxpayer because the IRS would not know of it unless it was reported.”⁵⁵ Discussions of side income usually also ended up in advice of expenses to offset the income.⁵⁶

The GAO study caused quite a stir, inspiring, in part, congressional hearings⁵⁷ and garnering a fair bit of media attention.⁵⁸ While informative, the GAO test, at the same time as highlighting problems, raised some important overall questions of the role that preparers play, especially in connection with fairly straightforward tax rules. The GAO report indicated the possible factors behind the high error rates; namely, it referred to the broad range of experience and lack of training of national chain employees, and to different standards paid preparers are governed by.⁵⁹ The GAO recommended that the IRS conduct research into the extent that preparers are living up to their responsibilities, and asked the IRS to consider whether the GAO’s use of its mystery shopper methodology was something that the IRS should employ to better gauge the quality of services that return preparers provide.⁶⁰

⁵⁴ Government Accountability Office, *Paid Tax Return Preparers: In A Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T, (2006).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ In 2007, the Senate Finance Committee held a hearing discussing many of the issues pointed out by the 2006 GAO study. The hearing included an update from the GAO on actions taken by the IRS in response to the 2006 study as well as statements from the Commissioner of the IRS. See *generally Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Mark Everson, Commissioner of IRS); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Michael R. Phillips, Deputy Inspector Gen. for Audit Treasury Inspector Gen. for Tax Admin.); *GAO 2007 Tax Filing Season Interim Results and Updates of Previous Assessments of Paid Preparers and IRS Modernization and Compliance Research Efforts: Hearing Before Sen. Fin. Comm.* 110th Cong. 2 n.3 (2007) (statement of James R. White, Dir. Strategic Issues and statement of David A. Powner, Dir. Information Technology Management Issues).

⁵⁸ See Albert Crenshaw, *Some Tax Preparers Don’t Add Up: Test of Commercial Firms Finds Errors in 19 of 19 Returns*, Washington Post (April 5, 2006) available at <http://www.washingtonpost.com/wp-dyn/content/article/2006/04/04/AR2006040401863.html> (detailing findings of GAO study).

⁵⁹ Different types of paid preparers (CPAs, attorneys, EAs, and unenrolled preparers) are subject to different governing standards. As discussed above, CPAs and attorneys may also be subject to different rules within the governing body of their professions. See Government Accountability Office, *Paid Tax Return Preparers: In A Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T, (2006).

⁶⁰ There has not been significant research into the quality of commercial return preparation, though the Casey Foundation has sponsored a limited research project. See Amy Brown for the Annie E. Casey Foundation, *Quality in Free and Commercial Tax Preparation: Results from the 2006 Tax Season* (June 2006). This study did a review of both free tax preparation sites as well as a small number of commercially prepared returns. The reviews looked at all aspects of each federal tax return. Seventy-three percent of all returns reviewed that had been prepared by paid practitioners had mistakes. Sixty-seven percent of returns prepared by tax practitioners contained material mistakes, *i.e.* those which changed the refund amount. By comparing the data of both the GAO and Casey Study, it can be seen that the mistakes found were similar. *Id.* The Casey Foundation and others have reviewed quality and error rates at various free return preparation sites, and similarly have found that many sites suffer from significant error rates. *Id.* See also Dustin Stamper, *IRS to Test Accuracy of Returns Prepared at Volunteer Income Tax Assistance Sites 2007 TNT 222-6* (Nov. 15, 2007) (addressing IRS concerns for VITA sites having just over 50 percent accuracy in recent years); Treasury Inspector General for Tax Administration, *Accuracy of Volunteer Tax Returns Is Improving, but Procedures Are Often Not Followed*, 2007-40-137 (Aug. 29, 2007) (reviewing preparation of income tax returns at IRS volunteer sites).

IV. Theoretical Context of Tax Gap Research

A. Tax Compliance Generally

Before considering the literature surrounding practitioners' role in tax compliance, it is important to understand the broader tax compliance research context in which this literature exists.⁶¹ Over the past thirty years a significant amount of research from a variety of social science disciplines considered tax compliance. Economists, psychologists and sociologists have contributed to the discussion, offering research and at times conflicting explanations regarding the dependent variable of whether a person is likely to comply with his obligations to file an accurate tax return.⁶² In the jargon of social science research, the unifying theme among this research is a search for explanatory reasons, referred to as independent variables, to help explain the factors that lead to noncompliance. The disciplines' approach to research reflects differing approaches to how and why the variables might be related and the various disciplines' choice of which variables to focus on reflects, in part, their assumptions about what motivates human behavior.

In broad terms, the economic models of tax compliance assume rational behavior, and that people will coldly consider compliance from the perspective as to whether the expected utility to noncomply exceeds the utility from complying. To that end, researchers relying on the economic model looked to a variety of independent variables likely to affect the calculus, including penalty rates, the likelihood of audit, and the tax rate and income level.⁶³ This research has become quite sophisticated. There are numerous studies testing the variables that economists believe contribute to taxpayers' decisions to comply with the tax laws.⁶⁴

Psychologists and sociologists have rightly pointed out that the economic model is insufficient as an explanatory tool. Sociologists and psychologists alike argue that framing a taxpayer as an amoral utility maximizer fails to capture the complexities of human behavior and relationships, and fails to explain why compliance rates exceed what would otherwise be expected if people were solely evaluating compliance in terms of dollars and cents.⁶⁵ According to Erich Kirchler:

the financial self-interest model assumes that tax compliance and evasion are outcomes of rational decisions based on audit probability, detection probability and sanctions. On the other hand, the behavioural model of tax evasion includes economic, psychological and sociological variables such as demographic character-

⁶¹ This overview is similar to that I summarized in Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 *Amer. L. Rev.* 1163 (2007).

⁶² I am indebted to the excellent theoretical overview of the respective social sciences approach to tax compliance research in Neil Brooks, *Challenge of Tax Compliance*, TAX ADMINISTRATION: FACING THE CHALLENGE OF THE FUTURE 19 (Eds. Evans and Greenbaum) (1998).

⁶³ Erich Kirchler, THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR 160 (Cambridge University Press 2007) (2007).

⁶⁴ For an excellent summary of the empirical research implicating the rational model of tax compliance, see Erich Kirchler, THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR 107-18 (Cambridge University Press 2007) (2007).

⁶⁵ E.g., Cooter & Eisenberg, *Symposium Norms and Corporate Law: Fairness, Character, and Efficiency in Firms*, 149 *U. Pa. L. Rev.* 1717, 1725 (2001).

istics (*e.g.*, education, income level, income source, occupation) social representations and attitudes (*e.g.*, tax ethics, and social norms, fairness perceptions), and structural characteristics (*e.g.*, complexity of the system, audit probability and detection probability, sanctions, and tax rates). Based on the rather small effects of variables considered in the neoclassical economic approach (*i.e.*, audit probability, fines, marginal tax rate and income), several studies conclude that it is important to consider also citizens' acceptance of political and administrative actions and attitudinal, moral and justice issues as they are central to psychological and sociological approaches. Andreoni, Erard and Feinstien consider the development of purely economic models of tax compliance from a perspective of game theory and principal agent theory. However, they add, these models are rather poor descriptions of real-world tax systems.⁶⁶

The research provides little in the way of a united theory on tax compliance. As Professor Brooks aptly summarizes, in a perfect or even merely orderly world the research would lead to:

a theory about why people comply with the tax law from which an interested tax administration department could deduce a comprehensive compliance strategy. No such theory has emerged from the research. Like much empirical research, we end up learning how much we do not know. In some of the research, it is difficult to be sure which way causation runs...in more controlled experiments conducted to test for causation there are problems generalizing the results...and theories based on some research have become so complex that they explain everything, by tautology.⁶⁷

The tax compliance literature is often lacking the sweep of context, of true understanding of patterns of human behavior.⁶⁸ To date, the quantitative approach to tax compliance has failed to offer satisfactory predictive generalizations. One perceptive commentator, Margaret McKerchar, in addressing the shortfalls in the compliance literature, notes that research has been driven by the need to find a model fitting all possible types of compliance behavior with the goal of the research to allow predictions to be made about the taxpaying population in general. "In doing so, assumptions ...were often unrealistic and therefore reduced the usefulness of the model to policymakers and administrators. For example, it is unlikely that taxpayers are all utility maximizers, risk averse or rational decision makers.... [P]eople exist in a dynamic environment where there are a great deal of

⁶⁶ Erich Kirchler, *THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR* 160 (Cambridge University Press 2007) (2007).

⁶⁷ Neil Brooks, *Challenge of Tax Compliance*, *TAX ADMINISTRATION: FACING THE CHALLENGE OF THE FUTURE* 22 (Evans and Greenbaum, eds. 1998).

⁶⁸ See Pauline Niemiowski, Steve Baldwin and Alex Wearing, *Thirty Years of Tax Compliance Research: of What Value Is It to the ATO*, *TAX ADMIN. IN THE 21ST CENTURY* 211-12 (Walpole and Evans, Eds.) (2001). These authors note studies identifying 64 variables for noncompliance, and bemoan the contradictory and inconclusive research: "Beliefs, personality traits, demographic variables and tax rates, opportunity, propensity to evade, and various external variables have also contributed to understanding compliance behaviour. Yet despite the extensive research, there is still a paucity of consistent reliable predictors or explanations of causality." *Id.*

influences, of which some are inconstant and others may not yet been identified or studied by researchers.”⁶⁹

Facing the inadequacy and shortfalls of the existing compliance literature, Professor McKerchar noted that researchers and policymakers would be better served by abandoning the search for a single model of taxpayer compliance, and considering the use of differing models “to explain differing types of compliance behaviour.” McKerchar continued by emphasizing the importance of identifying the various typologies of noncompliance,⁷⁰ and urges that additional studies relate to actual observed taxpayer behavior and focus group study.⁷¹

B. Tax Practitioner Research

There is relatively little IRS data, publicly released, that identifies and compares errors between self-prepared and practitioner-prepared returns.⁷² Like the tax compliance literature generally, the literature regarding the role that practitioners play in compliance has been growing in recent years but also is inconclusive. In a recent sweeping review of the studies to date, Professor Lin Mei Tan, at Massey University in New Zealand, stated that “it is not clear whether the tax practitioner is part of the tax compliance problem. Neither is it clear as to how ethically sensitive they are. What is clear is that they can influence the taxpayers’ compliance behavior.”⁷³ This insight is crucial for it holds out the hope for governments that they can, in some way, influence practitioners to influence taxpayers to comply with the internal revenue laws.

Key questions involve to what extent practitioners influence compliance decision of their clients, and to what extent the government uses tools to help practitioners be agents for greater taxpayer compliance or influence taxpayers in a manner that contributes to less non compliance. Professor Tan wrote extensively on the issue, looking at studies that considered the reasons for using tax practitioners, the studies exploring preferences for types of advice, how taxpayers choose their practitioner, and how taxpayers evaluate the services they receive. Studies from the tax practitioner’s perspective considered whether the use of a tax practitioner would result in lower compliance, and analyzed the variables that are related to practitioners’ willingness to be aggressive. Studies that have considered practitioner aggressiveness fall within three main categories: 1) decision context features (*e.g.*, legal ambiguity, practitioner penalties, probability of audit, size of tax benefit); 2)

⁶⁹ Margaret McKerchar, *Why Do Taxpayers Comply*, TAX ADMIN. IN THE 21ST CENTURY 242 (Walpole & Evans, Eds.) (2001).

⁷⁰ I began this project of applying the useful Kiddder/McEewn typology to low income taxpayers in 51 Kan Law Rev 1145 (2003) and continued it with a focus on commercial tax return preparers in my article in the Wisconsin Law Review, see generally Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 Wis. L. Rev. 1103 (2006).

⁷¹ Margaret McKerchar, *Why Do Taxpayers Comply*, TAX ADMIN. IN THE 21ST CENTURY 242 (Walpole & Evans, Eds.) (2001).

⁷² See Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 392 (Oct. 22, 2007) (stating that while the IRS has revitalized its tax gap research program since 2000, there are some measures of noncompliance where there is a need for additional information, including “relative compliance rates among taxpayers who prepare returns by hand, prepare returns with software, and use paid preparers”). *Id.*

⁷³ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 27 (Sawyer ed. 2006).

client's characteristics (e.g., client importance, risk preferences, year-end financial condition of client) and practitioner characteristics (e.g., practitioner demographics, including age, experience and education level; practitioner risk attitudes; type of practitioner; and size of establishment where practitioner works). Some of those studies are described below.

C. Who is the Real Instigator of Aggressive Advice?

Wading through the empirical evidence and studies leads to an inconclusive answer to the question as to who instigates noncompliant behavior, the taxpayer or the practitioner. The type of advice given by tax practitioners is usually classified as either “conservative” or “aggressive.” Hite and McGill defined aggressive as “taking a pro-taxpayer position on a questionable item.”⁷⁴ In their study, an aggressive position was “a situation where there is some reasonable probability that a particular tax return will not be upheld by an IRS review and subsequently legal challenge.”⁷⁵ They researched a random sample of U.S. residents with a hypothetical scenario.⁷⁶ The study showed taxpayers tended to agree with conservative advice from their practitioners but disagree with aggressive advice.⁷⁷ This suggests taxpayers prefer to be on the “safe side.”⁷⁸ Hite and McGill found that taxpayers do not prefer aggressive advice, and therefore suggested that “professional experience and tax education inculcates potential tax advisors with a prevailing professional culture of aggressive tax planning.”⁷⁹

In a study discussing how professional standards of conduct mitigate aggressive reporting by tax professionals, Cuccia, Hackenbrack, and Nelson concluded that a professional “made an aggressive reporting decision if the practitioner selects the reporting position that portrays events favorably when that position is not indicated clearly by the facts and relevant professional literature.”⁸⁰ The study looked at practitioner's actions when a standard is vague. The experiment provided subjects with “either an incentive to report aggressively or conservatively and a practice standard which employed a vague, verbal threshold.”⁸¹ Their results show that those who had an incentive to report aggressively made more liberal interpretations of the standard than those who had an incentive to report conservatively.⁸²

L. M. Tan conducted a study in New Zealand, based on the Hite and McGill study, on the taxpayer's preference for the type of advice.⁸³ The group surveyed was a more focused

⁷⁴ Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal 389, 390 (1992).

⁷⁵ See *Id.*

⁷⁶ See *Id.* at 389, 392.

⁷⁷ See Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal 389, 398 (1992).

⁷⁸ See *Id.*

⁷⁹ *Id.*

⁸⁰ Andrew D. Cuccia, et al., *The Ability of Professional Standards to Mitigate Aggressive Reporting*, 70 Accounting Review (1995).

⁸¹ *Id.*

⁸² *Id.*

⁸³ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006).

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group, using business taxpayers, most of whom engage tax practitioners to preparer their tax returns.⁸⁴ Tan found that most taxpayers tend to agree with advice, conservative or aggressive, given by their practitioner. This supports the notion presented by Hite and McGill that tax practitioners are the ones encouraging the aggressive positions as the taxpayers tend to agree with whatever advice is presented by their preparer.⁸⁵

While Hite and McGill and Tan's studies proposed that the tax practitioner pushes aggressive advice on the taxpayer, Schisler's study suggested that it is in fact the taxpayer who is the instigator of aggressive tax advice.⁸⁶ Schisler conducted an experimental study in the United States.⁸⁷ "As compared to tax practitioners, taxpayers are found to be more aggressive with tax due, to have lower equity perception of the tax system, and are more aggressive when ambiguous tax issues are involved."⁸⁸ This is contrary to the findings of Hite and McGill and Tan. Klepper and Nagin, in their study, analyzing data from the TCMP and Pennsylvania Department of Revenue, found that practitioners tend to improve compliance on items that are clear, but tend to help taxpayers exploit ambiguity by taking aggressive positions on ambiguous items.⁸⁹

Some studies support the view that practitioners view taxpayers as instigators of aggressive advice, but also recognize that the search for a single model that explains the complex dynamics of practitioner/taxpayer interaction is likely inadequate. Sakurai and Braithwaite,⁹⁰ for example, classify practitioners into three distinct types: 1) honest and risk adverse, 2) cautious minimizers of tax, and 3) the creative and aggressive planner. Sakurai and Braithwaite concluded that the latter is the least popular in terms of taxpayer preference, but that this aggressive practitioner type is of particular concern. They suggested that taxpayers are inclined to seek out preparers who share their values.⁹¹ This insight is consistent with Karlinsky and Bankman's study of sole proprietor noncompliance, where sole proprietors intent on minimizing income sought preparers they knew who would be comfortable

⁸⁴ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006).

⁸⁵ Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal 398 (1992). A number of studies have likewise found that a majority of taxpayers want their tax return preparer to file accurate tax returns, with minimizing taxes not the primary taxpayer objective. E.g., Collins, Milliron and Toy in *Journal of the American Taxation Association* (1990); Yuka Sakurai, and Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, Working Paper No. 5 (May 2001), available at <http://ctsi.anu.edu.au/publications/WP/5.pdf>.

⁸⁶ D.L. Schisler, *An Experimental Examination of Factors Affecting Tax Preparer's Aggressive – A prospect theory approach*, 16 The Journal of American Taxation Association 124 (1994).

⁸⁷ See D. L. Schisler, *An Experimental Examination of Factors Affecting Tax Preparer's Aggressive – A prospect theory approach*, 16 The Journal of American Taxation Association 124 (1994).

⁸⁸ *Id.*

⁸⁹ See Steven Klepper & Daniel Nagin, *The Role of Tax Preparers in Compliance*, 22 Policy Sciences 167-94 (1989).

⁹⁰ Yuka Sakurai, and Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, Working Paper No. 5 (May 2001), available at <http://ctsi.anu.edu.au/publications/WP/5.pdf>.

⁹¹ *Id.* at 22.

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with their approach.⁹² It is also consistent with Albert, Bloomquist and Edgerton's study of underreporting, which suggests that a relatively small amount of practitioners are responsible for a disproportionate share of underreporting of certain types of income.⁹³ Likewise, Kidder, and McEwen, adapting a sociological approach, postulated that there are different types of practitioners, those that broker or facilitate compliant behavior, and those that facilitate noncompliant behavior.⁹⁴

As Professor Tan indicated in her Research in *The Role of Tax Practitioners in Taxpayer Compliance: Understanding the Gaps*,⁹⁵ there are significant shortfalls in the literature to date:

The literature to date is not clear as to whether taxpayers are instigators of aggressive advice or whether tax practitioners comply with such demands. It is also not clear whether it is in fact the practitioner who influences their clients' tax compliance behaviour. With their reliance on tax practitioners, it is possible that some clients who prefer conservative advice may also be convinced by their practitioners to accept aggressive advice. Furthermore, it is also possible that practitioners may have incorrectly inferred the preferences of their clients.

Most prior studies failed to take into account the interactions between the taxpayers and their practitioners. Most studies were conducted from either the perspective of the taxpayer only or the practitioner only. These two categories of studies therefore present only one side of the picture. There is certainly a lack of knowl-

⁹² See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 164 (2002). Albert, Bloomquist, and Edgerton found that many errors were committed more frequently by self preparers, but that there was a higher incidence of potential Automatic Underreporting Program (AUR) misreporting (e.g. wages, mortgage interest, stock refunds and other items backstopped by third party information returns) among clients of paid practitioners. Albert, Bloomquist, and Edgerton found an inverse relationship between firm size and incidence of misreporting. In a case study focusing on Connecticut, the authors found that a small number of preparers were responsible for both a "significant percentage of potential AUR cases as well as the associated net underreporting amount ..." *Id* at 14. For example, the top 10 firms in Connecticut, in terms of number of AUR cases, accounted for 2.6 percent of Connecticut filers with potential misreporting and 4.7 percent of the almost \$5.8 billion in net underreporting amount. *Id* at 12-13 Table 5. The top 50 Connecticut filer accounted for 8.4 percent of all potential misreporting and a significant 11.4 percent of net potential underreporting amount. *Id*.

⁹³ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE (2007).

⁹⁴ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 TAXPAYER COMPLIANCE 47 (Jeffery Roth et al. eds., 1989).

⁹⁵ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006).

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edge of how tax practitioners and their clients interact or what the practitioner-client relationship is. This is a potential area for future research.⁹⁶

Tan's perceptive critique focused largely on practitioners' influence with respect to positions that have at their core some degree of uncertainty. Yet, the literature has not focused on practitioner influence on items that are not characterized by ambiguity. For unambiguous items, individuals present themselves to practitioners in three broad ways: 1) they want help in preparing their tax returns correctly; 2) they want assistance in facilitating the taking of improper positions, with assistance taking a variety of different forms; or 3) they do not have a strong preference and look to their practitioners for guidance.

As Sakurai and Braithwaite suggested, some practitioners, regardless of client preference, will not knowingly facilitate underreporting of sole proprietor income, nor will they assist people in claiming an EITC incorrectly. When taxpayers intent on underreporting visit that group of practitioners, practitioners may be able to moderate taxpayer behavior, though more research is needed to examine this. For example, how moderating can practitioners be? Can Congress or the IRS encourage practitioners to assist in encouraging taxpayers toward compliance without alienating taxpayers or contributing to taxpayers' potential concerns that practitioners may not have sufficient loyalty to their clients? If practitioners can, at least at the margin, temper improper taxpayer behavior, what actions should the government take to encourage taxpayers to visit the "right" type of preparers and educate preparers on the actions they can take to become positive influences on compliance? What role does skills and ethics training play in practitioners' willingness to facilitate or tolerate noncompliance? Should the government require only certain types of preparers to prepare more complex returns, or returns that research indicates have a potential for misreporting or error? Do we know enough about the characteristics or identities of practitioners who facilitate noncompliance, or is more research needed so we can better identify those practitioners? Should the government provide incentives to taxpayers or practitioners to facilitate the use of better or perhaps regulated preparers, or impose additional burdens or costs on those who fail to use preparers that will have a tendency to facilitate compliance?

⁹⁶ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006) (citations omitted). Tan notes that there are a number of areas that are ripe for additional research, including the following:

- ◆ An interesting research area that could be further explored is to what extent practitioners are willing to give in to the demands of their clients or to what extent clients are willing to adopt practitioners' advice
- ◆ Who (the client or the practitioner) has the greater influence on tax decisions?
- ◆ Does the length of the working relationship between the client and practitioner have any effect on the tax decision making?
- ◆ What factors steer the working relationship between the practitioner and the client?
- ◆ Is tax practitioners' advice affected by the firm size of their clients or other factors?
- ◆ Are practitioners client-driven?
- ◆ How do practitioners balance the requirements of the tax law, their clients' interest, their professional responsibilities and the demands of the organization that they work in?

Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006).

The above questions, McKerchar and Brooks' critique of tax compliance research generally, and Tan's critique of the tax compliance literature as it relates to practitioners, are all premised on a need for a deeper and layered approach to understanding the decision to comply with the tax laws. Researchers who seek deeper understanding have often turned to more qualitative approaches to problems. Few researchers have attempted to undertake a more qualitative analysis of tax noncompliance, which would allow for an inquiry that would include a search for contextualized findings.⁹⁷ There are varying definitions in the social science literature, but qualitative social science research methodology has at its core an "interpretive, naturalistic approach to its subject matter,"⁹⁸ and is an "inquiry process of understanding based on distinct methodological traditions of inquiry that explore a social or human problem"⁹⁹ involving the use and collection of a variety of empirical materials, including case studies, personal experience, focus groups, interviews, and participant observation. Unlike quantitative research, which seeks to generate data, and allow researchers to reach reliable and repeatable conclusions, qualitative research looks to collect data from the above methods, and generate ideas and hypotheses from these data largely through what is known as inductive reasoning.¹⁰⁰ The strength of good qualitative research is that it uses a variety of data collection methods that should touch the core of what is going on rather than skimming the surface.¹⁰¹ The goal of this type of research is to build a complex picture that goes beyond a focus on causal relationships, and would allow policymakers and researchers to gain a nuanced understanding which would create opportunities for researchers to hypothesize and test solutions that could then be subjected to rigorous statistical analysis.¹⁰²

Kidder and McEwen likewise emphasized the importance of exploratory ethnographic research and interviews as a basis for understanding the role of practitioners, suggesting that the role of practitioners may best be learned by observing interactions between

⁹⁷ For a refreshing example of a qualitative approach to reviewing noncompliance, see Joseph Bankman & Stuart Karlinsky, *Tax Evasion Behaviour and the Role of Their Tax Preparers*, in 5TH INTERNATIONAL CONFERENCE ON TAX ADMINISTRATION 136 (Walpole and Fisher eds. 2002). In their paper, the authors spoke with hundreds of independent contractors, business owners, information users and paid tax preparers, on conditions of confidentiality. Given the sensitive issues (including the possibility that the behavior of the subjects could give rise to civil and criminal sanction), the authors spoke on conditions of confidentiality, and some interviews were conducted on a web site that did not record the interviewee's IP address, and others were arranged over a web site and then conducted without the authors obtaining identification.

⁹⁸ THE HANDBOOK OF QUALITATIVE RESEARCH (Denzin & Lincoln, eds., Sage Publications) (1994).

⁹⁹ THE HANDBOOK OF QUALITATIVE RESEARCH (Denzin & Lincoln, eds., Sage Publications) (1994).

¹⁰⁰ See Adri Labuschagne, *Qualitative Research - Airy Fairy or Fundamental?* 8 The Qualitative Report1 (Mar. 1, 2003), available at <http://www.nova.edu/ssss/QR/QR8-1/>.html. See also Steven J. Taylor & Robert Bogdan, *Introduction to Qualitative Research Methods*, Wiley, (1998).

¹⁰¹ See Adri Labuschagne, *Qualitative Research - Airy Fairy or Fundamental?* 8 The Qualitative Report1 (Mar. 1, 2003), available at <http://www.nova.edu/ssss/QR/QR8-1/>.html. See also Steven J. Taylor & Robert Bogdan, *Introduction to Qualitative Research Methods*, Wiley, (1998); Bent Flyvbjerg, *Five Misunderstandings About Case Study Research*, 12 Qualitative Inquiry 219, 244-45 (2006) (at 244-45) (stating that good social science research often combines qualitative and quantitative research methods).

¹⁰² See Margaret McKerchar, *Why Do Taxpayers Comply*, TAX ADMIN. IN THE 21ST CENTURY 242 (Walpole & Evans, Eds.) (2001) (suggesting that a theoretical base can arise from working "backward[s] from outcome to decision processes to influence" with the possibility of this understanding leading to an appreciation of predictors which can also be tested quantitatively). In his insightful book, *Super Crunchers*, Professor Ian Ayres, in extolling the virtues of statistical analysis, rather than intuitive based decision-making, likewise recognizes that intuition and hypothesizing are crucial first steps toward statistical testing of possible solutions to problems. See Ian Ayres, *SUPER CRUNCHERS*, *Batnam* 124-125 (2007). The approach I suggest here is not an end in and of itself, but will hopefully assist policymakers in designing potential administrative and legislative solutions that can be subjected to careful statistical analysis, including the possible use of randomized testing and demonstration projects. *Id.* at 64-80.

practitioners and taxpayers. Kidder and McEwen recommended the creation of standard tax scenarios, and recommended bringing those scenarios to different preparers to evaluate how they treat specific tax situations.¹⁰³

V. Overview of the Role of the Practitioner in Sole Proprietor and EITC Noncompliance

The tax gap in 2001 attributable to the individual income tax was estimated at 245 billion¹⁰⁴ and accounted for 71 percent¹⁰⁵ of the total tax gap. The underreporting portion of the tax gap is the most significant of the overall gap. Individuals have increasingly turned to third parties, or tax return preparers, to prepare their tax returns. For example, in 2005, 80 million tax returns were prepared by paid practitioners, up from 63 million tax returns only nine years before.¹⁰⁶ In 2005, 62 percent of all tax returns were completed and signed by paid practitioners.¹⁰⁷

With the increased use of preparers it is becoming increasingly important to understand what role those preparers play in tax compliance. One interesting question is the role that practitioners play in facilitating the underreporting aspect of the tax gap, and, in particular, noncompliance among taxpayers who either overstate deductions or credits or who underreport income. The underreporting of the tax gap, and the way that the government can address the underreporting tax gap, has been the subject of increasing academic and governmental attention.¹⁰⁸ One area that has received relatively little attention is the role that practitioners play in tax noncompliance, especially in relation to items or taxpayers where there is little legal uncertainty.¹⁰⁹ This project is an attempt to raise questions and identify areas for future qualitative and quantitative research regarding the role of practitioners in tax compliance.

An important premise of this project is that there is not one particular compliance problem associated with the tax system, but rather many different compliance problems that vary greatly by issue and type of taxpayer. For example, the role of practitioners in noncompliance is different when one compares sophisticated high net worth individuals wishing to avoid or defer taxes from large gains associated with an entrepreneur's building and selling a high tech business to a small dry cleaner who comes to a self-employed public

¹⁰³ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 TAXPAYER COMPLIANCE 69-70 (Jeffery Roth et al. eds., 1989). Kidder and McEwen also suggest that researchers spend time as an assistant to the offices of practitioners or taking a temporary job at a national chain, with the purpose of understanding the role of practitioners through observation. *Id.* at 69.

¹⁰⁴ See Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 372 (Oct. 22, 2007).

¹⁰⁵ See *Id.* at 373.

¹⁰⁶ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007).

¹⁰⁷ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007).

¹⁰⁸ 2007 TAX GAP CONFERENCE PAPERS (June 2007).

¹⁰⁹ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 392 (Oct. 2, 2007).

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accountant and wants to file tax returns failing to show 100 percent of the business's gross receipts. Likewise, a low-wage single parent sharing custody of her child who wishes to get the maximum earned income tax credit generated-refund presents a different compliance picture than an upper middle class suburban woman who wants to sell her residence and has failed to maintain all records of home improvements to properly compute basis. There are many different types of taxpayers and practitioners, with noncompliance stemming from sophisticated tax shelters¹¹⁰ which may play on legal ambiguity, to relatively simple schemes based upon the straightforward and not too ambiguous decision to fail to report some percentage of income from a cash business.

In this project, I will look in depth at two areas of systemic individual noncompliance, the underreporting of income from the cash business sector, and the overstating of the earned income tax credit (EITC). Both represent significant areas of noncompliance. The underreporting of business income is the greatest component of the individual underreporting aspect of the tax gap, contributing to almost a third of the estimated tax gap.¹¹¹ The EITC is likewise important in that it has increasingly become the federal government's principal tool for addressing child poverty and rewarding low wage work.¹¹² The error rate in the EITC in 1999 was approximately 27 to 32 percent of all EITC payments,¹¹³ significantly higher than the overall tax compliance rate but lower than the estimated noncompliance rate among sole proprietors. Moreover, IRS, Congress, and GAO have highlighted EITC noncompliance over the past decade, and a series of IRS compliance studies focusing on the EITC, provides researchers with insights into the role that practitioners have played in its error rate.¹¹⁴

In recent years, there has been a significant amount of academic,¹¹⁵ administrative,¹¹⁶ and legislative¹¹⁷ attention on the errors associated with the EITC, with less focus on the tax gap

¹¹⁰ See Linda Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 Va. Tax Rev. 583, 587 (2006).

¹¹¹ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 370 (Oct. 22 2007).

¹¹² See Dennis Ventry, *From Competition to Cooperation: Imagining a New Tax Compliance Norm*, (draft 2007), Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005)

¹¹³ Earned Income Tax Credit Compliance, available at <http://www.whitehouse.gov/omb/budget/fy2004/pma/earnedincome.pdf>.

¹¹⁴ Crisis in the Tax Administration (Henry & Slemrod, eds., year) Janet Holtzblatt & Janet McCubbin, *Complicated Lives: Tax Administration Issues Affecting Low-Income Filers*, CONFERENCE ON THE CRISIS IN TAX ADMINISTRATION (2003).

¹¹⁵ E.g., Steven Holt, *Keeping it in Context: Earned Income Tax Credit and Treatment of the Working Poor*, 6 Conn. Pub. Int. L. J.183 (Spring 2007); Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005).

¹¹⁶ See IRS, IRS Earned Income Tax Credit (EITC) Initiative, at i-v (2005), http://www.irs.gov/pub/irsutl/irs_earned_income_tax_credit_initiative_final_report_to_congress_October_2005.pdf (discussing the results of the IRS's pilot program requiring 25,000 taxpayers to prove that children resided with the taxpayer for more than six months prior to a tax return being filed).

¹¹⁷ For a summary of the legislative efforts to resolve EITC noncompliance see Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005).

associated with sole proprietors.¹¹⁸ That lack of attention is starting to change, especially in light of the National Research Program (NRP)¹¹⁹ data highlighting the high rate of non-compliance and the high relative amount of the tax gap associated with sole proprietors. Given the relative lack of attention to sole proprietors, this section contains a more robust discussion of sole proprietor noncompliance, looking at the data the IRS recently released, as well as a review of some of the research that sheds light on the underlying causes for the high error rate in this sector.

A. Sole Proprietor Noncompliance

As mentioned above, the numbers associated with sole proprietor noncompliance are startlingly high. Sole proprietors are a fairly diverse group, but their hallmark in IRS compiled tax gap data is that they own unincorporated businesses and report their business receipts and expenses on their Form 1040 through the completion of a Schedule C. Proprietors with receipts under \$5,000 are allowed to report all their results on a simplified form, Schedule C-EZ. For 2003, the most current year that data is available, about 20.6 million sole proprietors filed income tax returns, with sole proprietors accounting for approximately 72 percent of all businesses in the US.¹²⁰ The taxpayers in this segment are diverse, from physical trainers, house cleaners, architects and hairstylists selling services, to EBAY sellers, small grocers, and people who make their living selling small homemade crafts.

One of the key distinctions between sole proprietors and wage earners is that the compliance rate for wage earners is very high,¹²¹ while most sole proprietors (about 61 percent) understated income, and that there was misreporting of about 57 percent of the net busi-

¹¹⁸ There are some notable exceptions to this. See Erich Kirchler, *The Economic Psychology of Tax Behaviour* 152-66 (Cambridge University Press 2007) (2007). Kirchler related sole proprietor noncompliance to broader research relating to the effects of external actions restricting choice. Kirchler, at p. 155. Kirchler suggested that in addition to sole proprietors' additional opportunities for noncompliance attributable to the lack of information reporting and withholding, sole proprietor noncompliance can be understood, in part, on an adverse reaction to the perceived and actual role that taxes (and out of pocket liabilities) play in restricting entrepreneurial freedom, especially at the beginning of sole proprietors' businesses, when risk of failure is high. See also Eliza Ahmed and Valerie Braithwaite, *Understanding Small Business Taxpayers*, 23 *International Small Business Journal* 539-568 (2005) (discussing the lack of academic attention to sole proprietors but mentioning exceptions). Recent promising research has looked at the relationship of sole proprietors and paid preparers. James Hasseldine, Peggy Hite, S. James, and M. Toumi, *Persuasive Communications: Tax compliance enforcement strategies for sole proprietors*, 24 *Contemporary Accounting Research* 171-94 (2007) (in controlled field experiment, testing the result of sanction and normative communications among self-prepared and paid-preparer returns in the United Kingdom). Hasseldine, Hite, James and Toumi's study builds on past studies that have considered persuasive communications as a means encouraging tax compliance. For example, See Richard Schwartz and Sonya Orleans, *On Legal Sanctions*, 34 *U. Chi. L. Rev.* 274-300 (1967); Marsha Blumenthal, Charles Christian, & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence From A Controlled Experiment In Minnesota*, 54 *National Tax Journal* 125-136 (2001). Hasseldine et al note the inconclusive research to date regarding preparers' roles in relation to tax compliance. Hasseldine, at 175. I intend to discuss their research model in future research connected with this project.

¹¹⁹ National Research Program Overview, IRS, <http://www.irs.gov/privacy/article/0,,id=139179,00.html> (last visited Nov. 30, 2007); IRS Updates Tax Gap Estimates, IRS, <http://www.irs.gov/newsroom/article/0,,id154496,00.html>.

¹²⁰ See Government Accountability Office, *Tax Gap: A Strategy For Reducing The Gap Should Include Options For Addressing Sole Proprietor Non Compliance* 10, GAO-07-1014 (July 2007).

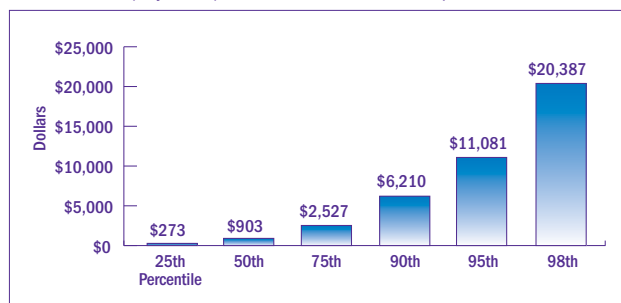
¹²¹ According to recent IRS estimates, amounts that are subject to substantial information reporting and withholding (like wages) account for only 1.2 percent of the net misreporting gap. IRS, *Tax Year 2001 Individual Income Tax Underreporting Gap* (Feb. 2007)

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ness income.¹²² Perhaps most interesting was GAO's identification that a small percentage of the taxpayers are responsible for most of the misreporting. GAO estimates that about 1.25 million taxpayers accounted for the largest ten percent of understatements, where the mean understated amount was about \$18,000.¹²³

GAO recently reported that the reasons for the high rates of sole proprietor noncompliance are "well known," focusing on the opportunity for concealment that is associated with the lack of third party reporting¹²⁴ and withholding on payments to proprietors.¹²⁵ The 2007 GAO report on identifying strategies to reduce sole proprietor noncompliance involved a broad approach, including providing additional educational outreach and assistance, especially to first-time filers, requiring separation of personal and business bank accounts, clarifying the rules distinguishing independent contractors and employees, imposing additional information reporting requirements, improving audit selection,¹²⁶ and enhancing the sharing of data with states. Interestingly despite data showing that approximately 73 percent of sole proprietors used paid practitioners in tax year 2005,¹²⁷ GAO does not discuss the role of practitioners, nor do any of the solutions highlight the important role that practitioners can play in this area.¹²⁸

¹²² See Government Accountability Office, *Tax Gap: A Strategy For Reducing The Gap Should Include Options For Addressing Sole Proprietor Non Compliance 17*, GAO-07-1014 (July 2007). The distribution of noncompliance is further illustrated by this table the GAO compiled from IRS data:



Government Accountability Office, *Tax Gap: A Strategy For Reducing the Gap Should Include Options For Addressing Sole Proprietor Non Compliance 10*, GAO-07-1014 (July 2007). Another 9 percent overstated their income. *Id.*

¹²³ Government Accountability Office, *Tax Gap: A Strategy For Reducing the Gap Should Include Options For Addressing Sole Proprietor Non Compliance 14*, GAO-07-1014 (July 2007).

¹²⁴ For a discussion of the limited reporting obligations associated to payments to sole proprietors, see Government Accountability Office, *Tax Gap: A Strategy For Reducing the Gap Should Include Options For Addressing Sole Proprietor Non Compliance 10*, GAO-07-1014 (July 2007).

¹²⁵ See *Id.* at 1.

¹²⁶ As Professor Bankman notes, while increasing audits (and the implicit audit increase likely inherent in an increase in information reporting) may have significant effects on reducing the gap, there is little political support for such an increase. Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 Tax Notes 506 (Oct. 29, 2007). Bankman perceptively notes that the average taxpayer would likely be skeptical of the IRS's ability to target audits to taxpayers likely to be evading, and he also notes the huge government and taxpayer resource issues associated with auditing sole proprietors. *Id.*

¹²⁷ IRS data shows that 15,008,081 Schedule C filers used a paid preparer out of a total 20,596,287 Schedule C filers in tax year 2005. Tax Year 2005, *IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF)*.

¹²⁸ The National Taxpayer Advocate has pointed out that there is very little in the way of consistent data regarding the "number and types of errors on returns, tracked by type of return preparer." National Taxpayer Advocate 2002 Annual Report to Congress 225.

B. EITC Noncompliance

A significant number of people who file returns purporting to be eligible for EITC benefits are not in fact eligible in whole or in part or are unable to demonstrate eligibility. A 1999 IRS study of EITC claims estimated that, of about 18.8 million tax returns (representing approximately \$31.3 billion in claims), between \$9.7 billion and \$11.1 billion of EITC claims were erroneous.¹²⁹ IRS enforcement activities prevented or recovered approximately \$1.2 billion in improper claims.¹³⁰ Thus, using upper range estimates, the IRS should not have paid approximately \$9.9 billion of the claims. More recent (2005) estimates of EITC noncompliance suggest that even after a number of legislative and administrative changes designed to improve the administration of the EITC, approximately 23 to 28 percent of EITC was paid or credited erroneously, with IRS enforcement preventing another \$2 billion in improper claims¹³¹

Analysis of tax-year compliance data from 1999 shows that 80 percent of the overclaims, and 75 percent of overclaim dollars stemming from those improper claims are attributable to three types of errors.¹³² These included: (1) approximately \$3 billion to qualifying child errors on 1.6 million returns; (2) approximately \$2 billion to filing status errors on 1.3 million returns; and (3) approximately \$1.9 billion to income misreporting errors on 3.6 million returns.¹³³ The most common qualifying child error involved claiming a child who did not live with the taxpayer for over half of the taxable year and therefore did not satisfy the EITC residency requirement.¹³⁴ Another common qualifying child error involved claiming a child who did not have the required relationship to the taxpayer.¹³⁵ The data shows much overlap among the common errors, as most children who did not meet the relationship requirement also did not meet the residency requirement.¹³⁶

Recent studies indicated that a significant amount of EITC overclaims were associated with returns that commercial preparers prepared. Of the approximately \$11 billion in upper-range estimated erroneous EITC claims made in 1999,¹³⁷ approximately 57 percent

¹²⁹ IRS, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns 3, 11 tbl.1 (2002). The noncompliance range is attributable to differing assumptions for those claimants who did not respond to the IRS compliance study. See *id.* at 3; Janet Holtzblatt & Janet McCubbin, *Complicated Lives: Tax Administration Issues Affecting Low-Income Filers*, CONFERENCE ON THE CRISIS IN TAX ADMINISTRATION 163 (2003).

¹³⁰ IRS, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns 3, 11 tbl.1 (2002).

¹³¹ This is based primarily on NRP data. *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Mark Everson, Commissioner of IRS). Examinations accounted for \$1.34 billion and math error adjustments accounted for \$330 million. The balance is from document matching activities.

¹³² IRS, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns 3, 13 tbl.2 (2002).

¹³³ *Id.*

¹³⁴ Administration of the Earned Income Credit, IRS Announcement 2003-40, at 1133 available at <http://www.irs.gov/newsroom/article/0,,id=110298,00.html>.

¹³⁵ Administration of the Earned Income Credit, IRS Announcement 2003-40, at 1133 available at <http://www.irs.gov/newsroom/article/0,,id=110298,00.html>.

¹³⁶ *Id.*

¹³⁷ Janet Holtzblatt & Janet McCubbin, *Complicated Lives: Tax Administration Issues Affecting Low-Income Filers*, CONFERENCE ON THE CRISIS IN TAX ADMINISTRATION 163 (2003).

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of the overclaims were attributable to returns prepared by commercial return preparers.¹³⁸ The overall error rate among taxpayers who reported using a preparer was 34.6 percent, compared with 37.8 percent among those who did not report using a paid preparer.

Also, there are significant variations in the error rate among the different type of preparers. In 1999, about 25 percent of the EITC was claimed in error. The 35.2 percent of the claimants using other commercial preparers had a much higher error rate of 36.2 percent.¹³⁹

Table 2.2.1¹⁴⁰

Type of preparation	Percent of Returns	Average EITC Claim	Average EITC Overclaim	Overclaim Rate	Margin of Error
CPA/Attorney	5.0%	\$ 1,279.22	\$ 260.45	20.4%	8.43%
EA/HR/JH	26.4%	\$ 1,917.67	\$ 499.08	26.0%	5.47%
Other Professional	32.4%	\$ 1,755.53	\$ 603.00	34.3%	3.80%

The presence of the EITC-generated refund and the ability to monetize the anticipated refund immediately (and thus pay the preparation and related costs) contribute to the presence of both the national marketplace leaders (like H & R Block), as well as local “mom and pop” storefront preparers (who often are not enrolled agents or accountants, but who are self-employed or working for smaller local firms).¹⁴¹ It is unclear whether the difference in error rates among classes of preparers is attributable to the preparers’ skills or scruples, or to the client characteristics of those using the different preparer types.¹⁴²

VI. A General Discussion of How Practitioners Facilitate Noncompliance

A. Introduction

Researchers recently emphasized the importance of understanding the practitioner’s role in brokering or facilitating noncompliance,¹⁴³ based in part on the insights of sociologists Robert Kidder and Craig McEwen.¹⁴⁴ Writing about the benefits of setting out such a typology, Kidder and McEwen remind us that viewing compliance variables too narrowly has the effect of limiting understanding of the complexities underlying taxpayer decisions

¹³⁸ National Taxpayer Advocate 2003 Annual Report to Congress 270.

¹³⁹ Janet Holtzblatt and Janet McCubbin, *Issues Affecting Low-Income Filers*, in *The Crisis in Tax Administration* 170-171 (Brookings Institution Press 2004).

¹⁴⁰ National Taxpayer Advocate 2002 Annual Report to Congress.

¹⁴¹ National Taxpayer Advocate, 2003 Annual Report to Congress 170-71; Alan Berube et al, The Brookings Institution, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*, p. 4 available at http://www.dlc.org/documents/Price_of_Paying_Taxes.pdf.

¹⁴² National Taxpayer Advocate 2003 Annual Report to Congress 171.

¹⁴³ See Kristina Murphy, *Aggressive Tax Planning: Differentiating Those Playing the Game from Those Who Don't*, 25 *Journal of Economic Psychology* 307, 309 (2004) (noting that until recently compliance research failed to “consider the potential impact of tax agents in the compliance process.”).

¹⁴⁴ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 *TAXPAYER COMPLIANCE* (Jeffery Roth et al. eds., 1989); see also Margaret McKechar, *Why Do Taxpayers Comply*, *TAX ADMIN. IN THE 21ST CENTURY* 242 (Walpole & Evans, Eds.) (2001).and Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, *TAXATION ISSUES IN THE TWENTY-FIRST CENTURY* 15 (2006) (citing to the utility of adapting the approach of Kidder McEwen).

whether to comply or not to comply with the tax laws.¹⁴⁵ Thus, as I have written elsewhere, as a necessary prerequisite to understanding the causes of noncompliance and the potential policies to redress noncompliance, one must define noncompliance based upon the various reasons why people comply or fail to comply in different areas of the tax law.

While a typology in and of itself is unlikely to completely capture the complexities of human behavior, nor allow us to statistically measure possible administrative or legislative efforts directed at reducing errors on returns that practitioners prepare, it does allow us to think more precisely about why tax returns prepared by paid preparers may have a significant level of errors. Kidder and McEwen identify brokered noncompliance as taxpayer noncompliance that is undertaken upon the direction of a knowledgeable tax expert.¹⁴⁶ This is a useful first step, but it can be broken up further to help us better understand the practitioner's role in the tax gap. As Kidder and McEwen discussed, much tax compliance literature focuses too narrowly on intentional violations, and the original Kidder/McEwen discussion of brokered noncompliance too narrowly considers advisors in that capacity.

As indicated in the literature survey above, research to date is inconsistent or at least unclear in helping us understand the role that practitioners play in tax compliance.¹⁴⁷ In an attempt to better understand the potential sources of noncompliance, in this project I am refining this understanding of brokered noncompliance. Yet, the research literature, my experience working in a legal clinic for ten years where I saw hundreds of taxpayers who filed incorrect tax returns that were prepared by practitioners, and the initial results of focus group studies that TAS and I have conducted,¹⁴⁸ suggested that crucial first steps in this inquiry include asking the fundamental question as to why a tax return that is prepared by a practitioner may be incorrect.¹⁴⁹

B. How Tax Return Preparers Can Contribute to Noncompliance

Preparers likely contribute to noncompliance in different ways. The following sets forth a listing of the number of ways practitioners likely contribute to returns that understate income or overstate applicable credits.

1. Ignorance or misunderstanding of the law—poor training or education, inadequate attention to changes in the law, or complexity of the law;

¹⁴⁵ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 *TAXPAYER COMPLIANCE* 48 (Jeffery Roth et al. eds., 1989).

¹⁴⁶ See *Id.* at 62.

¹⁴⁷ See Kristina Murphy, *Aggressive Tax Planning: Differentiating Those Playing the Game from Those Who Don't*, 25 *Journal of Economic Psychology* 307, 310 (2004) (noting after reviewing the literature that studies exploring the question of who instigates aggressive tax reporting have yielded contradictory results).

¹⁴⁸ The focus groups were conducted through out the summer of 2007, and involved a series of questions asked to practitioners that were meant to solicit their ideas about the role of preparers in noncompliance. In a later report, I will summarize and discuss the insights gleaned from the focus group sessions.

¹⁴⁹ By incorrect, I mean that the return is different from what the IRS would be legally owed by a taxpayer, assuming that the IRS and taxpayers share the same definition Marcello Bergman, *Criminal Law and Tax Compliance in Argentina: Testing the Limits of Deterrence*, 26 *International Journal of the Sociology of Law* (1999).

2. Misunderstanding or failing to understand or learn the facts—language or cultural barrier—can also be related to ignorance or misunderstanding of the law, as the practitioner may not know what information is relevant;¹⁵⁰
3. Unable or unwilling to detect false or incorrect information, though the unwillingness or inability is not reflective of failing to exercise due diligence;
4. Facilitate noncompliance by not exercising appropriate due diligence to verify facts or information;
5. Aid and abet in noncompliance by advising taxpayers how to misstate or omit income, or claim inappropriate or excessive deductions or credits;
6. Facilitate continued noncompliance by advising taxpayers how to arrange affairs to minimize chances of detection, including advising taxpayers on practices or positions that are likely to generate IRS attention;¹⁵¹
7. Directed noncompliance—working in an environment where there is a culture of noncompliance, either through insufficient quality control or active and affirmative exhortations to take affirmative steps which are meant to minimize liabilities or maximize refunds.¹⁵²

It is important to understand motivations for why brokers may intentionally or negligently facilitate taxpayer noncompliance. Items four through seven may arise from a perceived need to generate revenues from the activity (though taxpayers themselves get the lion's share of benefits), retain clients, attract new clients, and for some taxpayers (especially those seeking the EITC) position the firm or a business partner to benefit from the sale of refund generated products or services.

C. Types of Preparers—how preparers interact with taxpayers intent on understating their tax liability

An essential part of my setting out a structure of noncompliance is a realization that some taxpayers come to practitioners with the intent of understating their taxes or maximizing their refunds. Part B, above, considers the broader issues of errors on returns that are prepared by professional preparers, but within that broad category there is the particularly challenging issue of how preparers intersect with taxpayers who seek out practitioners to prepare and file erroneous returns that are noncompliant because the client is providing in-

¹⁵⁰ See A. Christensen, *Evaluation of Tax Services: A client and preparer perspective*, 14 *The Journal of the American Taxation Association* 60-87 (1992).

¹⁵¹ See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 164 (2002).

¹⁵² A clear example of this is the type of activities the government has alleged in a series of related civil injunction suits brought in connection with activities undertaken by franchise offices of Jackson Hewitt. See *U.S. Government Sues Jackson Hewitt Tax Preparation Franchises in Four States Alleging Pervasive Fraud* (April 3, 2007), available at <http://www.usdoj.gov/tax/txdv07215.htm>.

complete or inaccurate factual information to the preparer.¹⁵³ An interesting area of study is how practitioners react to those taxpayers. It is my hypothesis that practitioners who interact with those taxpayers intent on understating their taxes react in one of six ways:

1. Refusing Practitioners: This preparer refuses to accept as clients those they know or suspect as dishonest or inappropriately aggressive (or terminate the relationship once they gain knowledge or reasonable belief);
2. Signaling Practitioners: This preparer signals a refusal to prepare returns among those that they know or suspect are dishonest, through requesting back-up documentation or making detailed inquiries that contribute to the taxpayer's understanding that the practitioner is unwilling to prepare such returns;
3. Facilitating Practitioners: This preparer knows or has a reasonable suspicion that the taxpayer is misstating facts but facilitates noncompliance by advising taxpayers how to conceal or misstate income, or overstate or improperly generate deductions or credits;
4. Indifferent practitioners: This preparer is indifferent to the taxpayer conduct but willing to follow taxpayer preference and overlook noncompliance in which the preparer knows or has a strong suspicion is present;
5. Incompetent or Unsophisticated Preparers: Based upon what we would reasonably expect the practitioner to know given the practitioner's due diligence requirements, this preparer should be able to understand that the taxpayer is more likely than not overstating his credits or understating his liability, but this preparer is unable to detect or suspect client misconduct for a variety of reasons, including a lack of training, education, or sophistication; and
6. Reasonably Unknowing Practitioners: Despite the client conduct, the practitioner does not know and does not have sufficient basis to believe that the facts the client provides are incorrect.

There are some important policy questions that spin from understanding the above typology. As some research indicates, there is some support for the notion that taxpayers will listen to practitioners' advice about whether to comply with the tax laws.¹⁵⁴ Likewise, there is evidence that suggested that taxpayers seek out tax advisors who generally match their attitudes towards tax compliance.¹⁵⁵ It is possible, of course, that at least some taxpayers intent on improperly understating their income will seek out practitioners who will not make it difficult for them to noncomply, or file returns without the benefit of a preparer.

¹⁵³ As mentioned in the literature survey, some research suggests that taxpayers seek out practitioners with like values to themselves, especially when taxpayers are intent on minimizing taxes through underreporting of income. See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 164 (2002), Yuka Sakurai & Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, working Paper No. 5 (May 2001).

¹⁵⁴ See Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal, 398 (1992).

¹⁵⁵ See Sakurai, Y., and V. Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, working Paper No. 5 (May 2001).

Yet, assuming that preparers have some gatekeeping¹⁵⁶ role in the system, what can be done to push practitioners to become either type 1 or type 2 practitioners and encourage taxpayers to visit type 1 or type 2 preparers?¹⁵⁷ In addition, there are ways that the government can shift preparers from type 5 or type 6 preparers and generate possibilities for those preparers to become agents of compliance.

D. Example

The following example applies the categorizations in sections B and C above. The situation is complicated, of course, by the taxpayer's role in the noncompliance, and the variety of motivations and scenarios that taxpayers present, but it illustrates the challenges that researchers must confront in addressing the dynamics of noncompliance in this area.

Andrew, a 21 yr old single male lives in a one-bedroom apartment. He works on the evening shift at a warehouse, which starts at 6:00 p.m. His sister, Betty, is a single mom and has three kids: twin girls Debbie and Edna, age seven, and a three-year old boy, Frank. Betty lives with her mother Caroline, in a modest house Caroline owns. Betty has had a series of low-wage jobs, and has had substance abuse issues. In 2006 Betty and Andrew each earned \$12,000. Due to health issues, Caroline no longer works and receives Social Security disability income.

Andrew is especially fond of Frank, and cares for the boy, often at his house. He also has set up an area in his apartment where Frank can sleep over, which he often does on weekends.

Betty's friend Georgia is a hairdresser who also moonlights during tax season as a tax return preparer. She prepares about 18 tax returns a year for friends in the neighborhood. She charges \$50 per return, and she does not sign the return as a paid preparer. Georgia prepared Andrew's tax returns. 2006 is the first year that Andrew filed a tax return. Andrew filed as a head of household taxpayer, and claimed Frank as a dependent and qualifying child. Note also Georgia prepared Betty's return, and she filed as head of household, and claimed the twins as dependents and qualifying children for the EITC.

¹⁵⁶ It is likely that any increased gatekeeper responsibility will be met by significant professional opposition. See John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. Rev. 301 (2004) (noting the resistance that attorneys have raised in connection with post-Enron proposed increases in responsibilities and liabilities to the public, but emphasizing that in light of the social costs associated with misconduct it is increasingly unlikely that professions can maintain their guild-like self-governing role); R.H. Kraakman, *Gatekeepers: The Anatomy of Third-Part Enforcement Strategy*, 2 J.L. Econ. & Org., 53 (1986).

¹⁵⁷ Karlinsky and Bankman examine through field study interviews the role of the preparer with respect to cash business owners. In their study, Karlinsky and Bankman interview hundreds of people to, as the authors say, "get a feel" for what is happening in the world of small businesses, relative to the reporting of cash business income. To that end, the author, spoke with hundreds of business owners and various types of practitioners; including CPA, enrolled agents, bookkeeper, and accountants for the big five firms. In the study, Karlinsky and Bankman conclude that cash business owners rely on their own devices to significantly understate the income the business generates. In addition, the authors also conclude that there is a segmented market of practitioners, some of whom will tolerate not even a suspicion of client underreporting, with other practitioners turning a blind eye. Others provide active assistance in activities that will likely facilitate the taxpayer's behavior and make it more difficult for the government to detect. See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5th INT'L CONFERENCE ON TAX ADMIN. 166 (2002).

The effect of this is significant. If Andrew filed properly he would have taxable income of \$3,550 and a tax liability of \$358 (properly means filing single, without any dependents, qualifying children, or EITC). By claiming Frank as a qualifying child he reduced his tax liability to zero and qualified for a \$2,747 Child Tax Credit. The decision to allow Andrew to claim Frank does not affect Betty's liability whatsoever, as with either two or three qualifying children she would be eligible for a \$4,536 EITC and \$105 Child Tax Credit. Thus, this results in a shortfall to the fisc, of \$3,210.¹⁵⁸

What We Know About Andrew

As a legal matter, Andrew's error as it relates to his ability to claim Frank as a qualifying child for the EITC is that he and the child flunk the residency test.¹⁵⁹ In light of the IRS's compliance studies, we know that failure to satisfy the residency test is the most common reason why people like Frank erroneously claim the EITC.¹⁶⁰ We can identify a number of variables that may or may not be significant insofar as demonstrating a tendency that people like Frank would erroneously claim the EITC. For example, we could examine his age and gender, his education, his use of an unenrolled preparer who prepared fewer than 25 returns; his sister's having more than two children, his financial circumstances, and even his identification with society at large or affection for the government.

Assuming that we can identify variables that have a statistically significant relationship to the tendency of someone like Andrew to erroneously claim the EITC, consider, however, on reflection how difficult it is to identify the underlying reasons why Andrew improperly claimed Frank on his return. Here are some, and I suspect that there are more, given the complexities of human behavior:

Potential Reasons For Error

1. Georgia attempted to maximize the refund for Andrew, with Andrew assuming that Georgia prepared the return properly and genuinely not knowing that the return was incorrect;
2. Georgia attempted to maximize the refund for Andrew, with Andrew consenting to the approach after she explained what she was doing and why;
3. Georgia improperly applied the law and thought that Andrew could treat Frank as a qualifying child;

¹⁵⁸ This is the sum of the understated tax liability and the overstated credits. For a discussion of how the structural incentives within the EITC and CTC may influence demand for non compliance See Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 *Amer. L. Rev.* 1163, 1176-1177 (2007). See also Dorothy Brown, *The Tax Treatment of Children: Separate but Unequal*, 54 *Emory L.J.* 755, 789 (2005) (noting the unfairness of the CTC lower refundability for lower income individuals).

¹⁵⁹ To pass the residency test the two would have to share the same principal place of abode for greater than half the year. IRC §32(c)(3)(A) (referencing the definition of qualifying child under IRC §152(c)).

¹⁶⁰ IRS Announcement 2003-4, 2003-1 C.B. 1132 (discussing residence as the most common EITC error relating to qualifying child eligibility).

4. Georgia knew the law, but failed to or was not able to learn the appropriate facts so that she could properly prepare the tax return; and
5. Andrew misstated facts to Georgia.

From a researcher or policymaker's standpoint, it would be helpful to know why Andrew filed an incorrect return. What to do about the error should depend on whether the error was inadvertent or intentional. If intentional, it would be helpful to know whether the intent originated on the supply-side (*i.e.*, from the preparer), or on the demand-side, (*i.e.*, from the taxpayer). If inadvertent, a researcher would want to know what contributed to the mistake; for example, was it a cultural or language gap between the preparer and the taxpayer, or was it a lack of interviewing skills, or a shortfall in knowledge of the tax laws. Once a deeper understanding emerged, at that point more quantitative research might shed insight about what was effective in reducing that particular type of error.

Conclusion

This report is an invitation to additional research and a call for a deeper understanding of the sources of errors on commercially-prepared returns. With the growing importance and taxpayer use of practitioners, and continued interest in reducing the tax gap, it is inevitable that Congress and the IRS will look to practitioners' role in the tax gap, and consider their role in improving compliance.

In a subsequent report I will try to sharpen this focus and refine the practitioner-based typology further, postulate a theoretical context for legislative and administrative changes to assist in encouraging practitioners to act in a way that may encourage taxpayers to file correct tax returns, and make specific proposals that policymakers may wish to adopt or study further to test effectiveness. In addition, I will integrate qualitative research in the form of focus group sessions that I have conducted with a series of enrolled practitioners at various IRS-sponsored tax forums, and develop mystery shopper scenarios that can better capture the dynamics between differing commercial preparers and common taxpayer scenarios.

Annual Report to Congress

National Taxpayer Advocate

2007 Annual Report to Congress

EFFECT OF TAX INCREASE AND PREVENTION RECONCILIATION ACT OF 2005 ON IRS OFFER IN COMPROMISE PROGRAM

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Effect of Tax Increase and Prevention Reconciliation Act of 2005 On IRS Offer in Compromise Program

Executive Summary

The Tax Increase and Prevention Reconciliation Act (TIPRA) of 2005 was enacted on May 17, 2006. This act included a provision which required that taxpayers seeking to compromise their tax liabilities include a nonrefundable 20 percent payment along with lump-sum offers. The National Taxpayer Advocate believed that this legislation would have a “chilling” effect on taxpayers wishing to submit such offers. To test this hypothesis, she requested a study to estimate the effects of TIPRA on the IRS offer in compromise program.

TIPRA allows the IRS to waive the partial payment requirement for low income taxpayers. The initial income threshold used by the IRS to identify low income taxpayers included taxpayers living at or below the federal poverty level. Prior to the implementation of TIPRA, the IRS used this threshold to determine taxpayer eligibility for a waiver of the user fee required for the submission of an offer in compromise (OIC). The IRS has recently redefined low income taxpayers for this purpose as those whose income is at or below 250 percent of the federal poverty level.

This Taxpayer Advocate Service study was conducted using data obtained from a sample of closed, accepted offers from the two IRS campuses responsible for processing these cases.¹ Data from these sample cases were collected and tabulated to provide information on the source of offer funds, the availability of the 20 percent TIPRA payment, and the size of the offer, in addition to a variety of data on taxpayers’ income and assets. In addition to providing basic data on all sampled taxpayers, this report focuses on stratifying the data by two groups of taxpayers: those taxpayers with income above the poverty level but not exceeding 250 percent of the poverty level, and those taxpayers with income above 250 percent of the poverty level. More in-depth data was not provided on the group of taxpayers with incomes below the federal poverty level because this group was automatically eligible for the waiver of the 20 percent payment.

The most significant conclusions from this study appear below:

- Taxpayers with incomes above the poverty level or even with incomes above 250 percent of the poverty level are not significantly more likely to be able to afford the 20 percent TIPRA payment than those taxpayers with incomes at, or below, the poverty level.

¹ TAS sincerely appreciates the cooperation of the Small Business/Self Employed (SB/SE) Operating Division, which provided TAS access to these closed, accepted offer in compromise cases at the Memphis and Brookhaven campuses.

Effect of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program

- The most common source of offer funds is family and friends. It is unlikely that these third parties will provide funds for an offer since they are likely to forfeit 20 percent of the offered amount without compromising the liability for the taxpayer.
- Only half of the sample taxpayers below the poverty level are currently receiving waivers of the offer in compromise submission user fee. This finding suggests that some taxpayers eligible for a waiver of the 20 percent TIPRA payment will not be afforded this opportunity.²

Additionally, IRS offer receipts have, in fact, declined by about 21 percent from fiscal year (FY) 2006 to FY 2007. This decrease suggests that TIPRA may indeed have a “chilling” effect on the number of offer submissions. To address these issues, the National Taxpayer Advocate included the repeal of the 20 percent TIPRA payment as a legislative recommendation in her 2006 Annual Report to Congress.

Background

Section 7122 of the Internal Revenue Code (IRC) authorizes the IRS to compromise tax liabilities. The most common reason that the IRS compromises tax liabilities is because of doubt that the taxpayer has sufficient assets or income to satisfy the tax liability during the collection statute. Although by accepting an offer in compromise, the IRS is conceding the collection of the full amount of tax, penalties, and interest, studies have shown that the acceptance of offers is actually beneficial to the IRS as well as to the taxpayer. An IRS study of offers submitted from 1998 through 2003 showed that in 44 percent of the offers rejected by the IRS, only half of the amounts offered by taxpayers had been collected.³

Doubt as to collectibility offers may be submitted with a deposit of money to express the taxpayer’s good faith in submitting the offer, although prior to the enactment of the TIPRA legislation this practice was not encouraged because of the administrative burden on the IRS. Prior to the implementation of TIPRA, any deposit was held by the IRS pending its decision to accept or reject the offer. In the event of the offer’s rejection by the IRS, the offer deposit was returned to the taxpayer. Under the new law imposed by TIPRA, a lump-sum offer, one made in five or fewer installments, must include a payment of 20 percent of the amount offered. Other offers, called “periodic payment” offers, must be accompanied by a payment of the first proposed installment amount and these payments must continue

² Alternatively, some taxpayers may not obtain a waiver as a result of “procedural” or “lazy” noncompliance in which either administrative complexity is a hurdle or taxpayers are unwilling or unable to satisfy the requirements. For more information about types of noncompliance, see Les Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003), citing, Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 Taxpayer Compliance 57 (1989).

³ IRS Offers in Compromise Program, *Analysis of Various Aspects of the OIC Program* 11 (Sept. 2004). The study also concluded:

- The IRS eventually collected less than 80 percent of what individual taxpayers were offering in 54 percent of the OICs that it rejected and in 66 percent of the OICs that it returned after acceptance for processing.
- The IRS collected nothing from individual taxpayers in 21 percent of the OICs that it rejected and in 37 percent of the OICs that it returned after acceptance for processing. The IRS collected nothing from business taxpayers in 46 percent of the OICs that it rejected and in 60 percent of the OICs that it returned after acceptance for processing.

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until the IRS determines if the offer is acceptable or until the offer is withdrawn by the taxpayer. Under the law imposed by TIPRA, neither the 20 percent payment nor the periodic payments are refundable to the taxpayer. Of course, if the IRS accepts the offer, these amounts are deemed to be part of the offered amount; however, if the IRS rejects or returns the offer, the amounts are applied to the underlying liability, with the remaining amount still due from the taxpayer.⁴ This is a difficult and precarious position for the taxpayer, as the funds offered may be borrowed and will have to be repaid in addition to the uncompromised liability, or the funds may be a gift given for the purpose of the offer, but now forfeited under the TIPRA rules without accomplishing the intent of the party providing the funds. The fact that the IRS accepts less than one-quarter of all offers makes this collection alternative especially risky for taxpayers.

Both TIPRA and user fee regulations permit the IRS to exempt low income taxpayers from the user fee and 20 percent payment requirements. The IRS initially defined low income taxpayers as those with income at or below the federal poverty level. However, the IRS has recently redefined low income as those taxpayers with income at or below 250 percent of the federal poverty levels.

⁴ For offers deemed non-processable by the IRS, the user fee is returned to the taxpayer, but the partial payment is applied to the taxpayer's liability.

Introduction

The National Taxpayer Advocate requested a study to estimate the impact of TIPRA legislation on the ability of taxpayers to receive consideration of acceptable offers to compromise tax liabilities. The study was designed to examine the likely effects of TIPRA legislation on the IRS offer in compromise program. Specifically, the study explored a sample of closed offers that the IRS had accepted to determine the offer type and amount and to compare this information to taxpayer income, assets, and tax liability characteristics. Of most importance was the determination of whether the taxpayer had the ability to make the 20 percent partial payment and the source of funds for the offer, as these factors are most pertinent to the effect of TIPRA on taxpayers' ability to submit viable offers to compromise their tax liabilities.

This study was conducted in cooperation with the IRS's Small Business/Self-Employed (SB/SE) Operating Division. SB/SE personnel allowed TAS employees to review a sample of closed, accepted offers in both the Brookhaven and Memphis campuses, providing over 400 such offers for review.

In light of the waiver available for low income taxpayers to be exempted from the TIPRA user fee, the study results have also been stratified by whether the taxpayer submitting the offer had income at or below the poverty level, at or below 250 percent of the poverty level, or above the 250 percent of poverty level threshold. Some of the results of this study have already appeared in the National Taxpayer Advocate's 2006 Annual Report to Congress.⁵ However, this report contains a more comprehensive summary of all findings from the study.

Methodology

SB/SE agreed to make a sample of closed, accepted offers available for TAS personnel to review. Since offer in compromise case closing operations have been consolidated into the Brookhaven and Memphis campuses, SB/SE provided sample offer cases for review at each campus. For an attribute sample with a margin of plus or minus five percent at the 95 percent confidence level, an overall sample of about 400 cases was required.⁶ The sample was split between the Brookhaven and the Memphis campuses. It included both field and centralized offer cases and was extracted from cases that were being prepared for shipment to the Federal Records Center. Ultimately, the final sample contained 414 cases, 210 from Brookhaven and 204 from Memphis. A data collection instrument (DCI) was developed to capture the necessary data. The DCI was developed by examining the goals of the study and working with a TAS attorney advisor and other TAS employees with significant Collection and offer in compromise experience. The following items were included on the DCI: function working offer (field, COIC, Appeals), initial amount offered, final amount offered,

⁵ National Taxpayer Advocate 2006 Annual Report to Congress 515-516.

⁶ An attribute sample is designed to provide percentages of counts for sampled items or "attributes" within the specified margin, but for variable data such as dollar amounts, the margin may be larger (than the five percent for the attributes) because of the greater variability of such data.

type of entity making offer, type of offer (cash or deferred), source of funding, gross and net monthly income, future income, net assets, liquid assets, family size, presence of user fee waiver, evidence of special circumstances, and availability of the 20 percent offer payment. The DCIs were completed in September 2006, for offers accepted by the IRS in the months preceding the effective date of the TIPRA changes. The DCIs were completed by two TAS analysts, one in Brookhaven and one in Memphis. Both the Brookhaven and Memphis DCIs were intended to be completed on machine scannable forms; however, the Brookhaven DCIs were never received by the analyst, and this data was collected on an identical spreadsheet template. The Brookhaven and Memphis data were combined prior to final analysis. TAS Research assisted in the DCI design and performed all of the subsequent statistical analysis.

Limitations

An ideal sample would have been constituted from all offers accepted by the IRS over an extended period of time (*i.e.*, six months to a year); however, administrative processing of closed offers made such a sample prohibitive. Closed offer cases are boxed and shipped to the Federal Records Center as sufficient volumes accumulate. To construct a random sample from cases closed over an extended period of time would have involved ordering and finding about 400 different boxes from the FRC. Accordingly, the cases were sampled from the supply of offers available at each campus prior to their shipment to the FRC. To our knowledge, no systematic bias occurred in the extraction of the sample cases by SB/SE.

Another limitation of this study is that the TAS review presumed that the offer terms of the sample cases would be the same type of terms as those offers submitted after the effective date of the TIPRA legislation. The TAS study only examined the terms of the offer, as accepted, to determine the ability to make the required 20 percent TIPRA payment. TAS did not analyze whether the taxpayer could afford the TIPRA payment requirements, had the offer have been submitted with different terms.

Findings

The significant findings from this study appear in the following section. A complete list of all findings can be found in Appendices A, B, and C. Specifically, Appendix A contains the attribute percentages and mean and median confidence intervals for each of the study items for the sample as a whole. Appendix B contains the attribute percentages, means, and confidence intervals for each of the sample strata. Appendix C contains the medians and confidence intervals for each of the sample strata. As mentioned earlier, in addition to the presentation of the significant findings for all sample cases, separate breakouts are also shown for those offers submitted by taxpayers with income between 100 percent and 250 percent of the poverty level and those taxpayers with income above 250 percent of the poverty level, since these taxpayers would not have been eligible for a low income waiver of TIPRA's partial payment requirements.

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When considering the entire sample, over 71 percent of the offers were cash offers, and would require a 20 percent payment under TIPRA. The median accepted offer amount was over \$5,000, while the average amount was over \$13,000. The median net monthly income was slightly over \$650 with the average amount about \$1,000 higher. The median future income was zero, suggesting that requiring many taxpayers to pay with future income may be unrealistic. Nevertheless, the average amount was over \$8,000. Similarly, the median net assets were only about \$2,500, while the average amount was over \$10,000. As indicated in the following table, in over half of the cases reviewed, the source of the offered funds was the taxpayer's family or friends, with about 10 percent more of the offers funded from sources from which the 20 percent TIPRA payment could not be readily obtained.⁷

TABLE 2.3.1, Sources Of Offer In Compromise Funds

Category	Number	Percent	Margin (+/-)
Family/Friends	232	56.0%	4.8%
Commercial Loan	24	5.8%	2.3%
IRA/401K	9	2.2%	1.4%
Unsecured Credit	5	1.2%	1.1%
Property Sale	10	2.4%	1.5%
Current Income or Wages	123	29.7%	4.4%
Other	7	1.7%	1.2%
None	18	4.3%	2.0%
Total*	414		

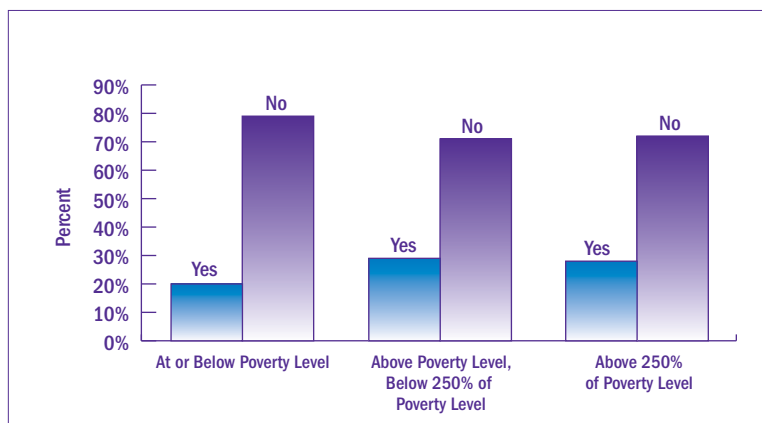
*Total Sample Cases. Question allowed multiple responses.

Ultimately, the review of the financial information contained in the case file determined that in about 70 percent of the offers, the 20 percent TIPRA payment was not available.⁸ Moreover, as the following chart illustrates, the inability to provide the 20 percent offer payment is almost as common in the higher income ranges.

⁷ Funds from a commercial loan, liquidation of an IRA or other retirement account, and the sale of property are not readily available for a taxpayer's use and obtaining funds from these sources may impose significant burden on the taxpayer.

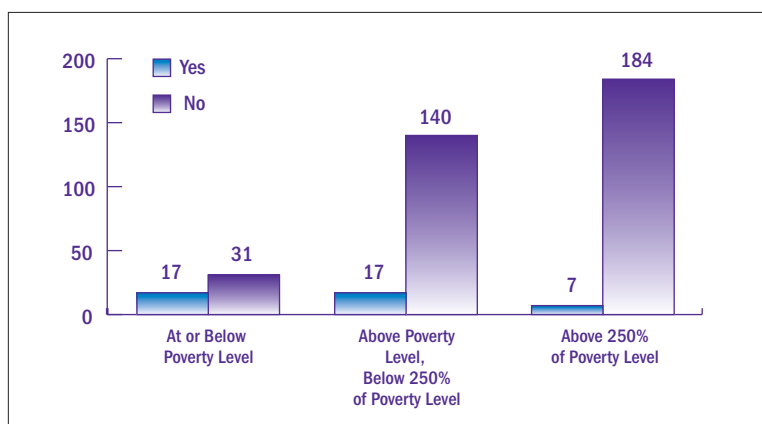
⁸ For purposes of the study, "liquid assets" included assets that could be liquidated and used for the TIPRA payment (e.g., cash, bank accounts, certificates of deposit, stock and securities) without incurring significant costs. For example, IRAs were excluded because a ten percent additional tax on early distributions applies to early withdrawals. The availability of the 20 percent TIPRA payment was based on the source of the offered funds and on whether the taxpayer's financial statement showed liquid assets that could be used to make the TIPRA payment. If the taxpayer indicated a personal source for the offer, or if the provided financial information showed the ability to make the payment, the 20 percent TIPRA payment was considered to be available. Otherwise the payment was considered to be not available. In the instance of deferred offers, if either the taxpayer's liquid assets or the analysis of the monthly income and expenses showed the ability to make the required TIPRA installment payments, the taxpayer was determined to be able to meet the TIPRA payment requirements.

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CHART 2.3.2, Availability of 20 Percent TIPRA Payment

Eighty-eight percent of the sampled cases were from taxpayers with incomes above the poverty level.⁹ Nearly 50 percent of the sample cases were from taxpayers with income above 250 percent of the federal poverty level, who would not be eligible for a waiver of the TIPRA 20 percent payment.

Since taxpayers with incomes at or below the poverty level are exempt from the 20 percent payment requirement, these sample cases will not be discussed in further detail. However, as shown in the following chart, it is interesting to note that the fee waiver for the user fee was present in less than half of these cases.¹⁰ The likelihood of the user fee being waived decreased progressively as the income strata rose.

CHART 2.3.3, OIC Fee Waivers

⁹ Poverty level was determined from the 2006 Federal Health and Human Services guidelines according to family size.

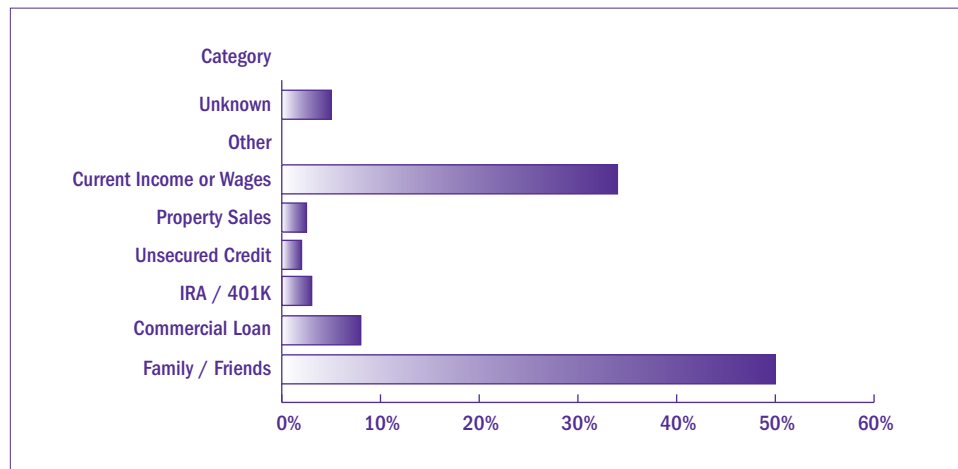
¹⁰ The upper bound of the 95 percent confidence interval for fee waivers present was 48.9 percent.

The following sections of this report will discuss the findings for the two groups of taxpayers whose ability to submit offers is most at risk from the new TIPRA legislation: taxpayers with income above 250 percent of the poverty level and taxpayers with income below 250 percent of poverty level, but above the base poverty level.

Incomes above 250 percent of Poverty Level

Over 60 percent of this income group submitted cash offers. The median accepted offer amount for taxpayers with incomes higher than 250 percent of the poverty level was over \$10,000, with the average accepted offer amount at nearly \$25,000. These taxpayers had similar average and median net monthly incomes at \$2,490 and \$2,269, respectively. The median future income for this group was \$3,264, while the average was over \$11,500. The median net assets were over \$4,000, while the average amount was over \$19,000. However, the liquid median assets were less than \$150 with the average amount at slightly over \$1,300. As with the sample as a whole, the primary source of funding for this group’s offers was family and friends. As indicated in the following chart, this source was primary for nearly half of the offers.

CHART 2.3.4, Sources of Offer Funding



Similar to each of the other income groups, the ability to provide the required 20 percent TIPRA payment was not present in about 70 percent of the cases.

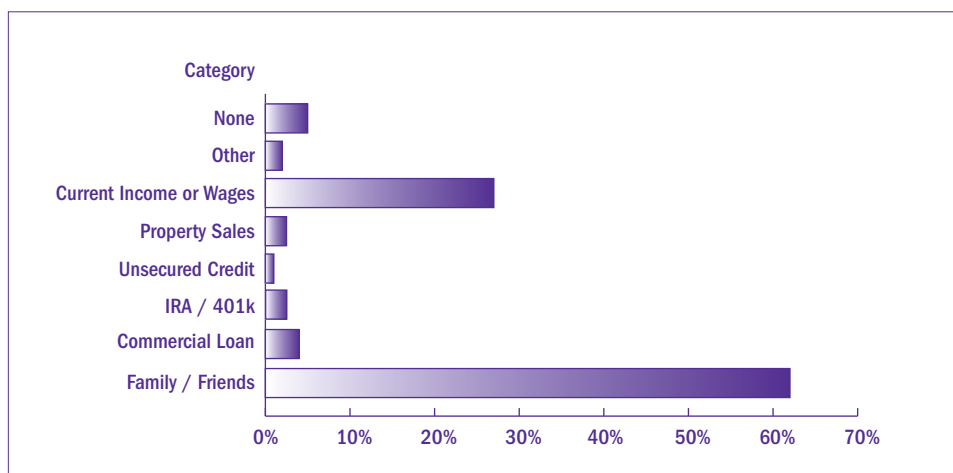
Incomes Above Poverty Level and Below 250 percent of Poverty Level

Nearly three-fourths of this income group submitted cash offers. The median accepted offer amount for taxpayers with incomes above poverty level, but below 250 percent of the poverty level, was about \$3,700 with the average accepted offer amount at nearly \$6,900. The median net monthly income for these taxpayers was less than \$100, while the average net monthly income was over \$1,000. The median future income for this group was zero, while the average amount was under \$2,000. The median net assets were less than

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\$2,000, while the average amount was over \$5,500. However, the liquid median assets were only \$100 with the average amount at less than \$500. Again, family and friends were the primary source of funding for this group's offers. As the chart below indicates, this source was cited for almost 60 percent of the offers.

CHART 2.3.5, Sources of Offer Funds



This group's ability to provide the required 20 percent TIPRA payment was also not present in about 70 percent of the cases.

Conclusions

Taxpayers with incomes above the poverty level are not significantly more likely to be able to afford the 20 percent TIPRA payment than those with incomes at, or below, the poverty level.

The most common source of offer funds is family and friends. It is unlikely that these third parties will provide funds for an offer since they are likely to forfeit 20 percent of the offered amount without compromising the liability for the taxpayer.

Although taxpayers in the higher income groups are more likely to have a higher value of assets, their liquid assets are still quite limited, reinforcing the concern that even these more affluent taxpayers will have difficulty submitting offers.

Less than half of the sample taxpayers below the poverty level are currently receiving waivers of the offer in compromise submission user fee. This fact suggests that some taxpayers eligible for waiver of the 20 percent TIPRA payment will not be afforded this opportunity.¹¹

IRS offer receipts have, in fact, declined by 21 percent from FY 2006 to FY 2007.¹²

Recommendations

The National Taxpayer Advocate submitted comprehensive recommendations for legislative changes affecting OICs in her recent 2006 Annual Report to Congress. These recommendations are reprinted below:

Modify Internal Revenue Code § 7122(c) so that taxpayers are not required to include a partial payment with “lump-sum” offer applications.

Alternatively, modify the OIC rules as follows:

1. Provide taxpayers with the right to appeal to the IRS Appeals function the IRS’s decision to return an OIC before or after accepting it for processing. The IRS could use the existing Collection Appeals Process, which allows it to review appeals in just five days.
2. Provide an exception to the partial payment requirement for taxpayers who do not have immediate access to current income and liquid assets that could be used to fund an offer without incurring significant costs (*e.g.*, taxable income or penalties resulting from the withdrawal of assets from a qualified retirement plan). For those taxpayers who have immediate access to such funds, the partial payment requirement should be 20 percent (for lump-sum offers) of any current income and liquid assets that could be disposed of immediately without significant cost.
3. Apply the low income exception in cases where payment of the combined OIC user fee and partial payment (or borrowing for such payments) would cause an economic hardship.¹³

¹¹ Alternatively, some taxpayers may not obtain a waiver as a result of “procedural” or “lazy” noncompliance in which either administrative complexity is a hurdle or taxpayers are unwilling or unable to satisfy the requirements. For more information about types of noncompliance, see Les Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003), citing Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, 2 Taxpayer Compliance 57 (1989).

¹² SB/SE Collection Activity Report No. 5000-108 (Oct. 1, 2007)

¹³ National Taxpayer Advocate 2006 Annual Report to Congress 519.

Appendix A – OIC Sample Results (not stratified by income)

Appendix A – OIC Sample Results (not stratified by income)¹⁴

Where was offer worked?

Category	Number	Percent	Margin (+/-)
Field	240	58.0%	4.8%
COIC	139	33.6%	4.5%
Appeals	35	8.5%	2.7%
Total	414		

Entity or individual?

Category	Number	Percent	Margin (+/-)
Individual*	394	95.9%	1.9%
Entity	17	4.1%	1.9%
Total	411		

*Includes TFRP (Trust Fund Recovery Penalty)

Type of Offer

Category	Number	Percent	Margin (+/-)
Cash	285	71.3%	4.4%
Deferred	115	28.8%	4.4%
Total	400		

Source of Funding

Category	Number	Percent	Margin (+/-)
Family / Friends	232	56.0%	4.8%
Commercial Loan	24	5.8%	2.3%
IRA / 401K	9	2.2%	1.4%
Unsecured Credit	5	1.2%	1.1%
Property Sale	10	2.4%	1.5%
Current Income or Wages	123	29.7%	4.4%
Other	7	1.7%	1.2%
None	18	4.3%	2.0%
Total*	414		

*Total Sample Cases. Question allowed multiple responses.

¹⁴ Totals may not add up to 100 percent due to rounding.

Appendix A – OIC Sample Results (not stratified by income)

Sample Characteristics

	Mean	Lower Limit	Upper Limit	Median Lower Limit	Median	Median Upper Limit
Initial Amount Offered	\$ 8,796	\$ 6,932	\$ 10,660	\$ 2,500	\$3,000	\$ 3,600
Gross Monthly Income (IET)	\$ 6,129	\$ 62	\$ 12,197	\$ 2,287	\$2,552	\$ 2,750
Net Monthly Income (IET)	\$ 1,651	\$ 1,445	\$ 1,858	\$ 257	\$ 652	\$ 1,199
Total Future Income (IET or AET)	\$ 8,006	\$ 6,243	\$ 9,769	\$ -	\$ -	\$ -
Net Assets (AET)	\$ 13,912	\$ 10,479	\$ 17,345	\$ 2,009	\$ 2,531	\$ 3,523
Liquid Assets	\$ 965	\$ 593	\$ 1,338	\$ 90	\$ 107	\$ 161
Accepted OIC Amount	\$16,171	\$ 13,392	\$ 18,951	\$ 5,000	\$5,233	\$ 6,297

Fee Waiver?

Category	Number	Percent	Margin (+/-)
Yes	42	10.3%	3.0%
No	364	89.7%	3.0%
Total	406		

Number of Family Members

	Mean	Lower Limit	Upper Limit
Family Members	2	2	3

Hardship, ETA, or Special Circumstances?

Category	Number	Percent	Margin (+/-)
Yes	21	5.1%	2.1%
No	392	94.9%	2.1%
Total	413		

TIPRA 20 Percent Payment Available?

Category	Number	Percent	Margin (+/-)
Yes	116	28.1%	4.3%
No	297	71.9%	4.3%
Total	413		

All margins and confidence intervals are expressed at the 95 percent level.

Appendix B – OIC Sample Results (stratified by income)

Appendix B – OIC Sample Results (stratified by income) ¹⁵

Where was offer worked?

Category	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)
Field	30	62.5%	13.7%	82	52.2%	7.8%	118	60.5%	6.9%
COIC	15	31.3%	13.1%	64	40.8%	7.7%	57	29.2%	6.4%
Appeals	3	6.3%	6.8%	11	7.0%	4.0%	20	10.3%	4.3%
Total	48			157			195		

Entity or Individual?

Category	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)
Individual*	45	93.8%	6.8%	152	96.8%	2.7%	187	96.9%	2.4%
Entity	3	6.3%	6.8%	5	3.2%	2.7%	6	3.1%	2.4%
Total	48			157			193		
*Includes TFRP									

Type of Offer

Category	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)
Cash	40	83.3%	10.5%	116	74.4%	6.9%	120	62.5%	6.8%
Deferred	8	16.7%	10.5%	40	25.6%	6.9%	72	37.5%	6.8%
Total	48			156			192		

¹⁵ Appendix B total case counts across all three strata are less than Appendix A total case counts because income information was not available to compute the strata for 14 cases. Totals may not add up to 100 percent due to rounding.

Appendix B – OIC Sample Results (stratified by income)

Source of Funding

Category	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)
Family/Friends	28	58.3%	13.9%	98	62.4%	7.6%	98	50.3%	7.0%
Commercial Loan	3	6.3%	6.8%	6	3.8%	3.0%	15	7.7%	3.7%
IRA/401K	1	2.1%	4.0%	3	1.9%	2.1%	5	2.6%	2.2%
Unsecured Credit	1	2.1%	4.0%	1	0.6%	1.2%	3	1.5%	1.7%
Property Sale	2	4.2%	5.7%	3	1.9%	2.1%	4	2.1%	2.0%
Current Income or Wages	11	22.9%	11.9%	43	27.4%	7.0%	66	33.8%	6.6%
Other	2	4.2%	5.7%	2	1.3%	1.8%	-	0.0%	0.0%
None	0	0.0%	0.0%	9	5.7%	3.6%	9	4.6%	2.9%
Total*	48			157			195		

*Total Sample Cases. Question allowed multiple responses.

Sample Characteristics

	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Mean	Lower Limit	Upper Limit	Mean	Lower Limit	Upper Limit	Mean	Lower Limit	Upper Limit
Initial Amount Offered	\$ 9,284	\$ 422	\$ 18,147	\$ 4,155	\$ 3,190	\$ 5,120	\$ 12,521	\$ 9,456	\$ 15,590
Gross Monthly Income (IET)	\$ 542	\$ 390	\$ 693	\$ 1,996	\$ 1,865	\$ 2,126	\$ 10,877	\$(1,798)	\$ 23,553
Net Monthly Income (IET)	\$ 502	\$ 260	\$ 745	\$ 1,035	\$ 830	\$ 1,239	\$ 2,490	\$ 2,132	\$ 2,848
Total Future Income (IET or AET)	\$ 262	\$(51)	\$ 576	\$ 1,899	\$ 1,001	\$ 2,798	\$ 14,849	\$ 11,535	\$ 18,163
Net Assets (AET)	\$ 20,096	\$ 5,212	\$ 34,981	\$ 5,647	\$ 3,851	\$ 7,443	\$ 19,336	\$ 13,453	\$ 25,219
Liquid Assets	\$ 213	\$ 123	\$ 303	\$ 471	\$ 332	\$ 610	\$ 1,322	\$ 703	\$ 1,942
Accepted OIC Amount	\$ 12,814	\$ 2,413	\$ 23,216	\$ 6,860	\$ 5,275	\$ 8,446	\$ 24,631	\$ 19,790	\$ 29,472

Fee Waiver?

Category	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)
Yes	17	35.4%	13.5%	17	10.8%	4.9%	7	3.7%	2.6%
No	31	64.6%	13.5%	140	89.2%	4.9%	184	96.3%	2.6%
Total	48			157			191		

Appendix B – OIC Sample Results (stratified by income)

Number of Family Members

	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Mean	Lower Limit	Upper Limit	Mean	Lower Limit	Upper Limit	Mean	Lower Limit	Upper Limit
Family Members	2	2	2	2	2	2	2	2	2

Hardship, ETA, or Special Circumstances?

Category	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)
Yes	2	4.2%	5.7%	7	4.5%	3.2%	12	6.2%	3.4%
No	46	95.8%	5.7%	150	95.5%	3.2%	183	93.8%	3.4%
Total	48			157			195		

TIPRA 20 Percent Payment Available?

Category	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)	Number	Percent	Margin (+/-)
Yes	10	20.8%	11.5%	46	29.3%	7.1%	56	28.7%	6.4%
No	38	79.2%	11.5%	111	70.7%	7.1%	139	71.3%	6.4%
Total	48			157			195		

All margins and confidence intervals are expressed at the 95 percent level.

Appendix C – Confidence Intervals for Medians

Appendix C – Confidence Intervals for Medians

Sample Characteristics

	At or Below Poverty Level			Above Poverty Level and At or Below 250% of Poverty Level			Above 250% of Poverty Level		
	Median	Lower Limit	Upper Limit	Median	Lower Limit	Upper Limit	Median	Lower Limit	Upper Limit
Initial Amount Offered	\$1,000	\$ 500	\$ 2,400	\$2,571	\$ 1,950	\$ 3,039	\$ 4,900	\$ 3,106	\$ 5,000
Gross Monthly Income (IET)	\$ 519	\$ 203	\$ 584	\$1,850	\$ 1,705	\$ 2,000	\$ 3,626	\$ 3,389	\$ 3,832
Net Monthly Income (IET)	\$ -	\$ -	\$ 23	\$ 73	\$ -	\$ 1,041	\$ 2,269	\$ 1,294	\$ 2,876
Total Future Income (IET or AET)	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3,264	\$ -	\$ 6,864
Net Assets (AET)	\$1,012	\$ 240	\$ 2,400	\$1,917	\$ 1,374	\$ 2,987	\$ 4,263	\$ 2,531	\$ 6,533
Liquid Assets	\$ 58	\$ -	\$ 149	\$ 100	\$ 50	\$ 195	\$ 148	\$ 98	\$ 222
Accepted OIC Amount	\$2,000	\$ 548	\$ 2,746	\$3,732	\$ 3,000	\$ 4,700	\$10,601	\$ 7,898	\$14,356
Family Members	1	1	2	1	1	2	2	1	2

All confidence intervals are expressed at the 95 percent level.

Effect of Tax Increase and Prevention Reconciliation Act of 2005 on IRS Offer in Compromise Program

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Annual Report to Congress

National Taxpayer Advocate

2007 Annual Report to Congress

THE IRS EIC AUDIT PROCESS — A CHALLENGE FOR TAXPAYERS

Annual Report to Congress

2007

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IRS Earned Income Credit Audits — A Challenge to Taxpayers

Executive Summary

This report outlines two key facets of IRS audits of taxpayers claiming the Earned Income Credit (EIC). The first section of the report details barriers faced by taxpayers when negotiating the EIC audit process. Potential EIC barriers were determined from targeted interviews with Low Income Taxpayer Clinic (LITC) attorneys and from tax preparer feedback at Taxpayer Advocate Service (TAS) focus groups with preparers at the IRS Tax Forums. Subsequently, a representative sample of audited taxpayers was surveyed to quantify the prevalence of these barriers. The second section of the report discusses EIC audit results which are likely related to the previously discussed barriers faced by taxpayers during EIC audits. Specifically, data show that taxpayers who are represented during an EIC audit fare significantly better than those taxpayers without representation during an EIC audit, even though relatively few EIC taxpayers obtain representation for their audit.¹

Barriers faced by taxpayers during EIC audits may be divided into three primary categories: communication, documentation, and process. Communication difficulties occur at the point of initial audit notification and throughout the audit as the IRS attempts to contact the taxpayer for information to verify the EIC claim. Audited taxpayers often reported difficulties obtaining requested documentation and substantial delays in IRS acknowledgment of provided documentation. The majority of taxpayers reported that they would prefer to communicate with the IRS about their audit in a manner other than by correspondence. Additionally taxpayers noted the necessity of sending in the same documents multiple times and providing new documentation not requested in the IRS' initial correspondence about the audit. Many respondents did not believe that the IRS considered all of the provided documentation when deciding the audit outcome.

The second section of this report compares EIC audit results from taxpayers with representation during the audit to taxpayers without representation. As mentioned, taxpayers fare better, in terms of keeping more EIC, if they have representation.² This report is an update of a previously published TAS Research report which examined EIC audit results from audits of tax year (TY) 2002 returns.³ Although the gap between EIC audit results of represented and unrepresented taxpayers has narrowed slightly between TY 2002 and TY 2004, the National Taxpayer Advocate is still concerned by the fact that unrepresented taxpayers do not receive as favorable an outcome as represented taxpayers. Moreover, the narrowing in the gap from TY 2002 to TY 2004 between the EIC audit outcomes of represented and unrepresented taxpayers is primarily attributable to represented taxpayers

¹ Only 1.8 percent of TY 2004 EIC audited taxpayers had representation during the audit, down from 3.5 percent in TY 2002.

² Results are based on TY 2004 audits completed by the end of June 2007.

³ Impact of Taxpayer Representation on the Outcome of Earned Income Credit Audits, August 2007, to be published in an upcoming Statistics of Income Research Bulletin.

having less success in the audit process, as opposed to unrepresented taxpayers faring better. Even though the results of TY 2004 audits show less favorable results than from TY 2002, the findings in this report show that unrepresented taxpayers are still significantly more likely to lose EIC during an audit than are represented taxpayers. Some will argue that represented taxpayers fare better in EIC audits because compliant taxpayers seek out representation; however, an analysis of self selection bias from the TY 2002 study showed that this presumption is not well founded.

The barriers faced by taxpayers during EIC audits and the gap in audit outcomes between represented and unrepresented taxpayers have important ramifications for the administration of EIC compliance. At a minimum, they suggest that corrective actions are necessary for the IRS to consistently reach the right conclusion on taxpayer eligibility for all taxpayers. While the National Taxpayer Advocate acknowledges the critical role that auditing serves in tax administration, IRS audit procedures must ensure that the correct audit determination is made. Failure to do so will erode taxpayer confidence in the fairness of the tax system. Moreover, inappropriately denying eligible taxpayers EIC deprives taxpayers of needed funds to support themselves and their families.

The key findings from this report are as follows:

Audit Barriers

- Less than one-third of EIC audited taxpayers thought the IRS audit notification letter was easy to understand, and only about half of the respondents felt that they knew what they needed to do in response to the audit letter.
- Over 90 percent of EIC audited taxpayers contacted the IRS about their audit.
- Nearly three-quarters of EIC audited taxpayers personally called or visited the IRS in response to the IRS audit notification letter, mostly due to communication issues. For example, 60 percent of those who contacted the IRS were seeking guidance on what documentation to send. More than half of the taxpayers undergoing an EIC audit reported that the IRS took more than 30 days to acknowledge receipt of their documentation or provided no acknowledgement.
- More than half of EIC audited taxpayers reported difficulties obtaining the documents requested by the IRS, and almost half of the taxpayers did not understand why the documents were requested by the IRS.
- More than 70 percent of EIC audited taxpayers stated a preference for an audit by a means other than correspondence.
- More than half of the EIC audited taxpayers who reported supplying all of the documents originally requested by the IRS also received an IRS request for additional documentation.
- More than one-third of the EIC audited taxpayers believed that the IRS did not consider all of their documentation.

Impact of Representation

- Taxpayers who use representatives are nearly twice as likely to be found eligible for the EIC as compared to taxpayers who are not represented during the audit process.
- Over 40 percent of all taxpayers with representatives emerged from their audit with their full EIC intact, whereas less than one in four taxpayers without a representative kept their full EIC.
- The taxpayers without representation were more likely to end up owing additional *tax* than taxpayers with representation (41 percent versus 23 percent).
- The vast majority of taxpayers who undergo an EIC audit do not have representation, and the number of taxpayers with representation during the EIC audit declined significantly from TY 2002 to TY 2004.

In response to these findings, the National Taxpayer Advocate makes the following recommendations.

- Increase taxpayer awareness of the legal assistance available at LITCs.
- Ensure all correspondence during the EIC audit provides taxpayers with references for contacting a LITC.
- Inform taxpayers of the closest LITC. Since these locations change annually taxpayers could be instructed to call TAS if the LITC is no longer participating in the program.
- If a taxpayer cannot provide all requested documentation to verify EIC eligibility, and the IRS has no information to dispute the EIC claim, allow the taxpayer to provide an affidavit from an IRS approved source to prove EIC eligibility.
- Assign one worker to each EIC audit. Provide the worker's name, phone number, and address in all correspondence with the taxpayer.
- Call taxpayers, whenever possible, to see if verbal communication can resolve any miscommunication.
- Revise EIC audit letters. Letters should be written to address the taxpayers' personal tax return and should specifically state that the taxpayers' tax return is being audited. The letters should clearly list the specific issues of the audit and explain what the taxpayer must do to resolve each issue, and should also explain how the documentation relates to the issue in question.
- Provide timely acknowledgements to all documentation and materials received from the taxpayer.
- Inform taxpayers of the right to a face-to-face audit and what steps must be taken to request the audit be changed to face-to-face.
- Provide a checklist that taxpayers can use to guide them in securing the proper documents and steps needed to validate their eligibility.

Introduction

The IRS administers the Earned Income Credit (EIC) to millions of taxpayers each year.⁴ An important aspect of effective tax administration is to ensure the accuracy of the EIC claims. One way the IRS does this is by auditing some of the returns filed. The outcome of the audit presumably validates the taxpayers' eligibility for the EIC. As a matter of fairness and effective tax administration, the IRS must work with taxpayers and their representatives to ensure the EIC is accurately claimed.

EIC audits represent approximately 40 percent of all IRS individual taxpayer audits.⁵ The vast majority of these taxpayers do not have professional representation during the audit. This is perhaps not too surprising, given the income level of these taxpayers and their likely unfamiliarity in dealing with the IRS on issues involving complicated matters of tax law. Anecdotal reviews of EIC audits, where EIC was disallowed, show that frequently there is no significant evidence that the taxpayer was ineligible. Instead, the taxpayer failed to prove EIC eligibility.⁶ For example, when asked to provide school records to verify the six months residency requirement, taxpayers often submit records for a single school year. Given that a typical school year overlaps two calendar years, this information is insufficient to prove residency to the IRS, but is not evidence that the taxpayer is ineligible for the credit.

The law clearly places the burden of proof on the taxpayer, but if the taxpayer cannot sufficiently understand the rules or negotiate the audit process, reaching the goal of a correct audit outcome is brought into question. The National Taxpayer Advocate is compelled to ask if the lack of representation during an audit puts EIC taxpayers at an inherent disadvantage over those taxpayers who are represented. Accordingly, the National Taxpayer Advocate wanted to both explore the audit process from the taxpayer's perspective and to examine the audit outcome, particularly with respect to whether the taxpayer had assistance with the navigation of the audit process. Taxpayer Advocate Service (TAS) Research approached the analysis of EIC audits in two ways. In one approach, TAS⁷ developed a study using surveys to obtain taxpayer information regarding their experiences with the audit process. This survey especially focused on barriers that taxpayers face in responding to an IRS EIC audit. In the second approach, TAS examined the outcome of EIC audits to determine if the use of a representative enabled a taxpayer to keep his or her EIC, or at least retain a larger amount of it after the audit.⁸

⁴ Over 22 million filers claimed EIC in TY 2004, EIC Fact Sheet for TY 2004 as of December 31, 2005.

⁵ IRS, *FY 2006 Data Book*, Table 9 (40.3 percent or 517,617 EIC audits).

⁶ Wage & Investment Research review of 43 closed EIC audits.

⁷ In conjunction with Wage & Investment Research and the EIC Program Office.

⁸ A representative includes an attorney, certified public accountant, enrolled agent, or an unenrolled preparer who prepared the tax return under audit.

Ideally, the EIC audit process would be painless for taxpayers, and the IRS would be able to reach the right outcome on EIC eligibility regardless of the presence of a representative.⁹ As we will see in the body of this report, taxpayers face several barriers during the EIC audit process. Furthermore, the use of a representative does appear to have a significant impact on the outcome of the audit and the amount of the EIC retained by the taxpayer. These findings suggest the IRS must work harder and smarter to reach an accurate resolution to the EIC eligibility issues, particularly when the taxpayer does not have a representative.¹⁰

Given scarce resources, the IRS and taxpayers will be challenged to find a way to better verify EIC eligibility in an audit environment. The IRS simply cannot provide a representative to each taxpayer. Nevertheless, the IRS can improve the EIC audit process as well as suggest free representative alternatives to taxpayers. The National Taxpayer Advocate believes this study compels the IRS to find new ways of reaching out to those taxpayers who do not have representation. The awarding of EIC to ineligible taxpayers costs the government billions of dollars; however, disallowing EIC to those taxpayers truly eligible for the credit is negatively impacting their already fragile financial well being.

Background

Prior IRS studies indicate a significant proportion of claimants historically have not been entitled to the Earned Income Credit (EIC). For example, of the approximately \$31.3 billion in EIC claims made by taxpayers who filed TY 1999 returns in 2000, it is estimated that between \$8.5 and \$9.9 billion (27 percent to 32 percent) should not have been paid.¹¹ These estimates were derived by auditing a sample of 3,457 taxpayer returns that claimed the EIC. TAS is interested in knowing if administrative barriers contribute to taxpayers being unable to prove EIC eligibility and if taxpayers would have fared better (*i.e.*, kept their EIC or lost less of their EIC) had they obtained representation.

TAS recognizes the critical role that auditing serves in tax administration. IRS audits help ensure taxpayer compliance and protect the tax revenue base. However, the National Taxpayer Advocate is concerned by the findings from recent focus groups and targeted interviews with taxpayer representatives regarding barriers taxpayers face during IRS audits. TAS conducted focus groups with taxpayer representatives at the 2005 IRS tax forums and also initiated targeted interviews with LITC attorneys to discuss problems with audit processes relevant to EIC. In particular, TAS sought to learn what barriers the representatives perceived that prevented the IRS and the taxpayers from reaching the correct outcome on EIC eligibility and amount claimed. The representatives identified several barriers including inconsistent IRS requests for documentation, lost paperwork, and poor

⁹ After controlling for self-selection by taxpayers that use a representative, the IRS would presumably find similar rates of EIC eligibility.

¹⁰ The IRS must also ensure that represented taxpayers do not unfairly receive EIC.

¹¹ IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns*, (Feb. 28, 2002). Tax returns were filed in 2000 for TY1999.

communication.¹² These identified barriers formed the basis for a TAS survey conducted in conjunction with the EIC Program Office and Wage & Investment (W&I) Research to obtain input from taxpayers regarding their EIC audit experiences, including barriers faced by taxpayers during audits.

The National Taxpayer Advocate is concerned that various barriers are preventing the IRS from treating taxpayers fairly. In particular, TAS wants to achieve a proper balance between EIC compliance and accurately determining taxpayers' eligibility for the EIC. If these barriers are preventing the IRS and taxpayers from accurately determining the correct amount of EIC, the IRS may be inadvertently denying taxpayers a credit they are legitimately entitled to.

EIC filers have several attributes that may hinder their ability to respond effectively to an audit.¹³ These attributes may impede the communication and understanding of requests made by the IRS during an audit of the taxpayers' EIC. These problems are exacerbated by the IRS administrative barriers raised in the previously discussed focus groups and interviews. TAS is concerned these taxpayer attributes and aforementioned barriers are leading the IRS to improperly deny taxpayers their EIC.

The National Taxpayer Advocate recognizes the repercussions this may have on tax administration. She tasked TAS Research to explore the following two issues:

Audit Barriers

- *Identify the type and frequency of barriers faced by taxpayers during EIC audits.*

Impacts of Representation

- *Determine if taxpayers who have representation fare better in EIC audits as compared to those who do not have representation?¹⁴*

If a significant number of taxpayers are affected by substantive audit barriers, and if represented taxpayers fare better in an EIC audit than unrepresented taxpayers, the IRS must reconsider its approach to EIC audits. The IRS will need to develop compliance programs that verify the EIC in such a way as to minimize the use of audits or modify the way the

¹² The National Taxpayer Advocate's Findings from Correspondence Examination Focus Groups, IRS Tax Forums June – September 2005, December 2005 and Taxpayer Advocate Service's Challenges for Taxpayers Claiming the Earned Income Tax Credit (EIC), from interviews with Low Income Taxpayer Clinics, September 2005. The studies suggested that taxpayers often possess only rudimentary literacy skills, and do not understand IRS' generalized correspondence; they do not understand what supporting documentation needs to prove; and they struggle because they do not have one IRS worker assigned to their case. Participants suggested that IRS should at least: review all relevant documents and information it possesses about a case in a timely manner and prior to requesting more documentation; assign one worker to each case and provide taxpayers with their name and telephone number; develop a checklist of information required for EIC claimants, and be specific about what information taxpayers should send and whether documents should be original or copies.

¹³ Attributes of EIC filers include: less likely to speak English; less education, lower income levels. *Playing by the Rules, but Losing the Game – America's Working Poor*, Urban Institute <http://www.urban.org/publications/410404.html>. These attributes suggest that EIC taxpayers may be less likely to understand IRS correspondence and less able to afford representation (i.e., power of attorney) with IRS.

¹⁴ This issue was explored through the analysis of three objectives: Determining rate of EIC change, proportion of EIC retained, and rate of tax change.

audits are conducted. Such potential changes could impact tens of thousands of taxpayers who claim the EIC.

Research Methods

Audit Barriers

The Audit Barriers study focused on taxpayers who claimed EIC for TY 2004 and whose tax returns were audited. Taxpayers were selected using the Automated Information Management System (AIMS) TY 2004 audit data. The original study data contained 387,821 TY 2004 returns closed between March 2005 and April 2006. Some taxpayers were excluded from sample selection as follows:

1. Taxpayers in a Federal Emergency Management Agency (FEMA) declared disaster area;
2. Taxpayers with undelivered¹⁵ audit notices, since they never participated in the audit process;
3. Taxpayers who filed a Form 1040X, due to insufficient data regarding the claim;
4. Taxpayers who were selected for audit as part of a special EIC projects (EIC Pre-Certification, EIC Post Refund Filing Status, EIC Single Issue Audit Test, EIC Criminal Investigation Fraud Referrals, and EIC Fraud projects¹⁶), since they received different audit notices;
5. Taxpayers who did not file a tax return prior to the audit, since they were not part of the target population; and
6. Taxpayers who were under criminal investigation.

A simple random sample (without replacement) was generated from the remaining population of 230,127 audited EIC tax returns. The sampling plan was designed to achieve an overall accuracy of plus or minus five percent at the 95 percent confidence level, assuming the rate of occurrence for a particular answer to a question to be 50 percent.

Using a multiple wave process, nearly 4,000 surveys were mailed to taxpayers who claimed EIC and were audited. The response rate for the survey was about 24 percent.¹⁷ An analysis of the respondents showed close similarity to the EIC audit population across a variety of demographic characteristics. Therefore, the survey results are likely reflective of the general EIC audit population for TY 2004, even though the response rate is relatively low.¹⁸ The mailing consisted of four different products: first, a postcard was

¹⁵ Undelivered mail was determined from the AIMS technique code field.

¹⁶ The project codes eliminated from this study were project codes 132, 576, 577, 579, 580, 581, 584, 585, 691, and 710.

¹⁷ Surveys were mailed to 3,960 taxpayers; however, mail was returned as undeliverable to 811 of these taxpayers. Surveys were returned from 754 different taxpayers.

¹⁸ Survey percentages in this report have a margin of error of plus or minus 4 percent at the 95 percent confidence level.

mailed approximately one week *prior* to the survey; the next mailing consisted of a cover letter, copy of the survey, and a self-addressed stamped envelope;¹⁹ the third mailing was a follow-up postcard (sent to everyone in the sample) as a thank you to respondents and as a reminder to those who had not responded, and a final mailing (sent only to non-responders) included a second survey cover letter, replacement survey, and self addressed, first-class postage paid return envelope.²⁰

Impact of Representation

The population studied in this analysis was comprised of TY 2004 returns audited for EIC issues. EIC returns were selected for audit through various means including Dependent Database (DDb) processing, Discriminate Income Function (DIF), and EIC Recertification procedures.²¹ TY 2004 was chosen since it is the most recent tax year for which most of the audits have been completed. We are also reporting on TY 2002 audits, so that we may review case activities that occurred subsequent to the close of the initial audit.²² For this study, TAS Research selected cases from the AIMS closed case database by project code. The list of project codes used to determine EIC audit cases was obtained from the EIC Program Office. We determined that some returns in these project codes never claimed or received EIC, according to IRS Masterfile data, and therefore removed them from our analysis. We removed some additional returns from our study because insufficient data was available for analysis.²³

We supplemented the AIMS population data with other individual tax return data to obtain items such as amount of EIC claimed by the taxpayer and allowed by the IRS, as well as income information from the return, and entity items such as filing status and return preparation method. Lastly, we used the Compliance Research Initiative Tracking System (CRITS)²⁴ to obtain additional data necessary to analyze the outcome of the audits. Most notably, we obtained the IRS Masterfile transactions²⁵ for the credit and debit of EIC. We used this transaction data to determine the amount of EIC claimed by the taxpayer, allowed by the IRS during return processing, and the amount of EIC ultimately allowed after the initial audit of the return. Masterfile transaction code data was also utilized to verify the presence of representation during the audit.

¹⁹ The first two mailings provided background to the survey, stressed the importance of the survey, and requested that the respondent reply quickly.

²⁰ Surveys were made available in English and Spanish. Each contact mailing also contained a message that if a Spanish language survey was preferred, taxpayers could request the materials in Spanish by calling a toll-free number. Those calling the number were asked to leave a message saying they needed the survey in Spanish and providing the control number at the top of the survey. A total of twelve taxpayers who were mailed a survey called and requested a Spanish survey. Only five of the twelve that were mailed the Spanish version actually returned the survey.

²¹ If EIC for any year after 1996 was denied or reduced for any reason other than a mathematical or clerical error, a Form 8862 is required to be filed with the next tax return if claiming EIC with qualifying children.

²² TAS Research previously published a report on the effect of representation on TY 2002 EIC audits. This report is designed to serve as an update of the previous analysis of TY 2002 audits; however, sufficient time has not elapsed to comprehensively review post audit activity on the TY 2004 EIC audits.

²³ See data limitations in the following section.

²⁴ CRITS data contains current Individual Returns Transaction File (IRTF) and Masterfile data elements.

²⁵ The IRS posts debits (*i.e.*, tax assessments) and credits (*e.g.*, EIC credit) to a taxpayer's account with different codes so that the type of each debit or credit may be clearly identified. Separate codes are also used to denote other account activity such as the authorization of a representative for a taxpayer.

We then split the population data into two groups: those taxpayers with representation during the audit and those without representation. The determination of whether a taxpayer was represented during audit was made by the presence or absence and timing of specific Masterfile transaction codes which show whether a taxpayer has representation. Additionally, we used the Centralized Authorization File (CAF) data to identify represented taxpayers. The CAF data also identifies the type of representative.²⁶ The CAF data was cross-referenced with the Masterfile transaction codes indicating the presence or removal of a representative. In a few cases, the CAF and Masterfile data were discrepant and these cases were removed from the study population.²⁷

We used Masterfile transaction codes to split transaction code data from the Masterfile into four time periods: before audit, first audit, second audit,²⁸ and after audit. Transaction codes with cycles posting before the Examination start date were included in the before audit time period. We included transaction codes with cycles posting between the Examination start date and the first audit disposition date in the first audit period. The second audit time period included transaction codes posting between the first audit disposition date and the second audit disposition date. We incorporated transaction codes after the last audit disposition date in the after audit time period. We defined representation,²⁹ EIC change,³⁰ and tax change³¹ for each of the time periods. This report includes analysis using the before audit and first audit time periods for TY 2004 audits. A separate section on the post audit period is also included for TY 2002 audit results.³²

Unless otherwise noted, the findings are based on a dataset containing 427,807 taxpayers. Of these returns only 7,688 (1.8 percent) were represented in the original audit. The original study data contained 476,178 returns³³ with an EIC project code. However, as described in the following limitations section, several circumstances necessitated the removal of returns from the study.

Limitations

When analyzing the data, TAS Research discovered several anomalies in the data for the population of TY 2004 EIC taxpayers who were audited. Based on this analysis, we eliminated returns with the following characteristics from the population:

²⁶ For example, attorney, certified public accountant, enrolled agent, or an unenrolled preparer, etc.

²⁷ 854 cases were removed for this reason.

²⁸ A small number of cases (225) did not have a transaction code 421 denoting the end of the audit. In these instances, we used the AIMS disposal date to determine the ending point of the audit. Because of the lag between AIMS and Masterfile, we added four cycles to the AIMS disposal date to determine the proper audit closing date.

²⁹ Representation is noted on a tax module by transaction codes 960, 961 and 962.

³⁰ EIC change was determined from transaction codes 764, 765, and 768.

³¹ We used transaction codes 290, 291, 294, 295, 300, 301, 304, and 305 to compute tax change.

³² Sufficient time has not elapsed to fully examine the TY 2004 post audit period.

³³ Data extracted as of August 2007.

1. Taxpayers who did not claim EIC on their tax return or did not check the box on their tax return to have the IRS compute EIC for them (10,060);
2. Taxpayers with undelivered³⁴ audit notices were removed since they never participated in the audit process (31,630);
3. Taxpayers whose filing status was Married Filing Separate (MFS). This group was eliminated due to incomplete information on changes to filing status (*i.e.* – Married Filing Separate to Head of Household) (20);
4. Taxpayers with missing tax return data on the CRITS or Compliance Data Warehouse (CDW) (115);
5. Taxpayers who filed a Form 1040X were removed due to insufficient data regarding the claim (5,692); and
6. Taxpayers with inconsistent representation information on Masterfile (transaction code 960) and CAF data (854).³⁵

During data analysis, TAS Research also observed instances where the data showed the taxpayer did not have qualifying children, but EIC before audit and the change in EIC due to the audit were greater than the maximum amount of EIC allowed for taxpayers without children. To correct for this anomaly, we updated the number of qualifying children based upon the EIC Table in Publication 596 for TY 2004.³⁶

Findings

Audit Barriers³⁷

The Audit Barriers Survey project was designed to determine the type and frequency of barriers faced by taxpayers during EIC audits. For reporting purposes, these barriers and their prevalence have been compiled into three objectives as described hereafter.

Objective 1: Identify and quantify communication problems associated with taxpayers' notification by the IRS of an EIC audit.

The IRS sends letters to notify taxpayers claiming EIC that their tax return is being audited. However, the letters are unclear and difficult for many of the recipients to understand. Overall, more than one-quarter of taxpayers receiving an EIC audit notice did not understand that the IRS was auditing their return. An even larger percentage, almost 40 percent, of the respondents did not understand what the IRS was questioning about their EIC claim.

³⁴ Undelivered mail was determined from the AIMS technique code field.

³⁵ The CAF data file contains information from the Form 2848, Power of Attorney and Declaration of Representative. For purposes of this study, a taxpayer was considered represented if the representative authorization appeared on both the CAF and the IRS Masterfile.

³⁶ There were 155 of these cases.

³⁷ Survey data for the Audit Barriers findings were cleaned to enforce skip patterns in the survey. A complete summary of the Audit Barriers survey findings are contained in a report by W&I Research entitled, EITC Audit Barriers Study Project # 6-05-12-048E, September 2007.

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Similarly, only about half of the respondents felt that they knew what they needed to do in response to the audit letter.

More than 70 percent of the respondents did not think that the audit notification letter was easy to understand.³⁸ The majority of those respondents who struggled to comprehend the letter stated that the terms, explanations, and instructions made understanding the letter difficult. The most common complaints about the letter are summarized below:

TABLE 1, Understanding the Audit Letter

Difficulties with IRS Letter	Percentage of Respondents
Did not understand IRS was auditing return	26.5%
Did not understand what IRS was questioning	38.9%
Difficulties with Understanding Letter	
▪ Did not understand some words/terms	42.7%
▪ Letter did not explain what documents to send to the IRS	22.0%
▪ Instructions were hard to follow	16.2%
▪ Tone of letter scared taxpayer	16.4%
▪ Hard to read	11.2%

The remaining respondents listed other specific complaints or did not remember the letter sufficiently.

Even though slightly over half of the respondents indicated that they understood what was being questioned and knew what they needed to do, overall, more than 90 percent contacted the IRS. Seventy-two percent of the respondents said that they either called or visited the IRS in response to the letter. More than 75 percent of those taxpayers contacting the IRS about their audit letter did so by telephone. The most common reasons for contacting the IRS about the letter were for assistance with understanding the letter (45 percent) and for assistance with determining what documentation to send (60 percent).

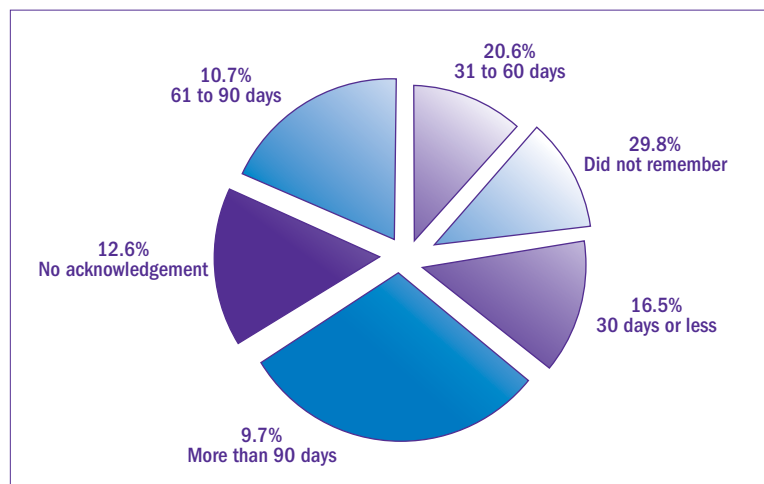
About 87 percent of respondents reported contacting someone for help after receiving the IRS letter informing them that their tax return was being audited. Respondents reported contacting the IRS more than any other avenue for help, followed by contacting paid preparers, a friend, relative, or neighbor, or a Low Income Taxpayer Clinic (LITC).

³⁸ Those who did not understand what the IRS was questioning on their tax return were much more likely than those who did understand what IRS was questioning to find the letter hard to read, to find terms difficult to understand, to have problems following letter instructions, to state that the letter did not say what to send to IRS, and to be scared by the tone of the letter.

Objective 2: Describe and quantify problems faced by taxpayers as they attempt to provide documents to substantiate their EIC eligibility.

As indicated in the following chart, taxpayers who responded to the IRS with documentation to support their EIC claim generally experienced long wait times for the IRS to acknowledge receipt of the documentation, with some claiming to receive no acknowledgement.³⁹

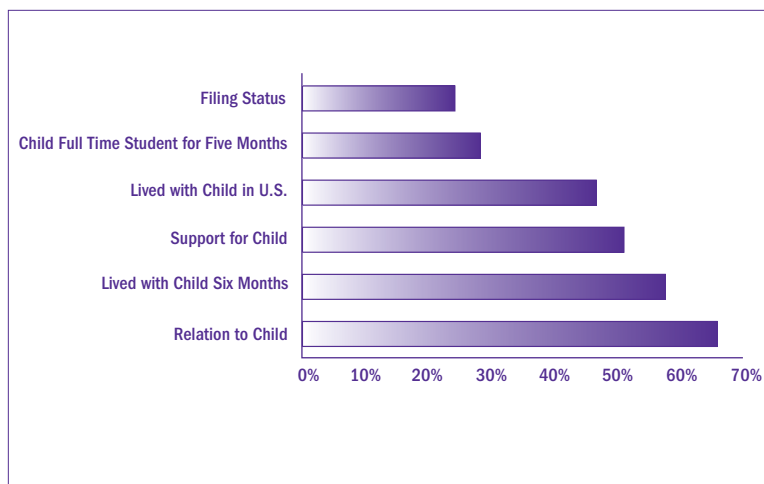
CHART 1, Time for IRS to Acknowledge Receipt of Documents



The IRS requests documentation to verify a variety of EIC eligibility factors. Most of the respondents were asked to prove more than one issue pertaining to EIC.⁴⁰ The following chart depicts the eligibility factors which taxpayers most frequently reported as being issues in their audit.

³⁹ Respondents who reported sending no documentation were directed to skip this question. Results are based on 621 respondents, which still provides a margin of error of plus or minus four percent at the 95 percent confidence level.

⁴⁰ Respondents were asked to provide documentation on multiple issues: 33.2 percent were asked to prove two to three issues, 33.2 percent were asked for documentation to prove four to five issues, and another 10.9 percent had to prove more than six issues.

CHART 2, Issues Requiring Additional Documentation

A little more than half of the respondents (55 percent) indicated an understanding of how the documents would answer the IRS questions about the EIC Claim.

About 41 percent of the respondents indicated that obtaining the required documentation was easy. The remainder reported a variety of obstacles in obtaining the documentation. The most common difficulties are summarized in the following table:

TABLE 2, Obtaining Documentation

Difficulty with Obtaining Documents	Percentage of Respondents
Take time off work	20.9%
Could not find all documents	17.6%
Did not keep records	15.9%
Did not know what documents needed	12.3%
Did not know where to get documents	10.3%
Had to pay for documents	10.2%

Nearly two-thirds of the respondents indicated that they sent the documents requested by the IRS.

Objective 3: Describe taxpayer experiences during the EIC audit, including process barriers which hinder prompt and accurate audit resolution.

In addition to problems with the IRS's communication of the audit notification and required documentation, taxpayers also reported a variety of problems with the EIC audit process. Perhaps of most concern is that more than 70 percent of respondents prefer

to communicate with IRS in a manner other than correspondence, with 46 percent of respondents preferring to communicate about their audit with the IRS by telephone, and another 23 percent preferring to communicate in person. About a third of the respondents reported that it was easy to communicate with the IRS by correspondence, while more than half of the respondents reported that it was easy to communicate with the IRS by telephone. Nevertheless, the IRS routinely conducts the vast majority of its EIC audits by correspondence. Regarding their experience when contacting the IRS concerning their audit notice, only about half of the taxpayers rated the IRS as helpful. The most common complaints are summarized below:

TABLE 3, Contacting IRS

Experience When Contacting IRS	Percentage of Respondents
Could not talk to the same person	31.8%
Did not understand IRS response	18.7%
IRS did not have all documents regarding audit case	14.5%
IRS worker was not familiar with audit case	13.1%

One of the difficulties of the correspondence audit process is ensuring that the proper documentation is received and considered by the IRS. Only 42 percent of participants who stated they sent in all the documents requested in the initial letter were not asked for additional documentation. About 39 percent of the respondents reported having to send the same documents multiple times, while about 19 percent were asked for different documents than those stated in the IRS' initial request. When evaluating the result of the audit, 35 percent of the respondents believed the IRS had not considered all of their submitted documentation. The most common documents reported as not being considered are presented in the following table:

TABLE 4, Documents not Considered

Documents Not Considered	Percentage of Respondents
Birth Certificate	54.9%
School Records	48.1%
Social Security Number	46.2%
Medical Records	29.1%
Utility Records	26.1%
Lease Agreement	21.6%

Similar to the percentage of respondents who believed that the IRS did not consider all of their submitted documentation, 36 percent of respondents did not believe the IRS made the correct decision regarding their EIC audit.

IRS Earned Income Credit Audits — A Challenge to Taxpayers

Given the variety of difficulties with navigating the audit process, it is not surprising that few of the respondents attempted to respond to the IRS audit without some type of assistance. In many instances, the taxpayers sought assistance directly from the IRS, yet only about half of the respondents found the IRS to be helpful.

Given the significant barriers encountered by EIC taxpayers during the audit process, one must consider whether many audited taxpayers are truly ineligible for EIC, or whether they were just unable to successfully navigate the IRS audit process. To this end, the National Taxpayer Advocate has postulated that taxpayers with representatives during EIC audits fare better than their non-represented counterparts. The following section of this report will explore this possibility.

Impact of Representation

Objective 1: Determine if taxpayers with representation in EIC audits are more likely to be determined eligible for EIC (and to have a higher no change rate) than taxpayers without representation in EIC audits.

Finding: Represented taxpayers are nearly twice as likely to be found eligible for EIC and to have no changes made to their EIC.

Table 5 depicts the percentage of taxpayers who retained at least some EIC after audit. Clearly, represented taxpayers were much more likely to retain their EIC after audit than those taxpayers without representation. In fact, taxpayers who used a representative during the audit process were nearly twice as likely to be determined EIC eligible when compared to taxpayers without representation.⁴¹

TABLE 5, EIC Retained/Disallowed During Audit

Percentage of Taxpayers with:	Not Represented	Represented
No change in EIC ⁴²	23.1%	41.5%
EIC reduced	4.3%	6.1%
EIC disallowed in full	72.6%	52.4%
Total	100.0%	100.0%

Source: IRTF TY 2004 & CAF for TY 2004

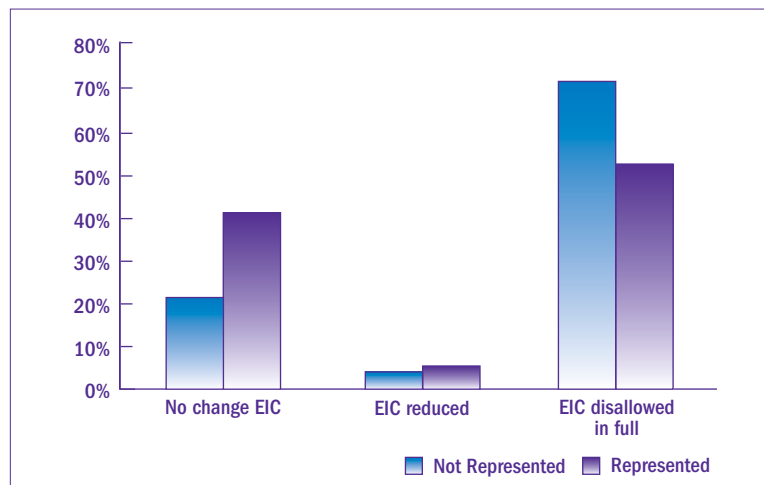
Likewise, Table 5 shows that the “no change” rate for represented taxpayers is also nearly double that for the unrepresented taxpayers. A comparison of the data in this table indicates that relatively few taxpayers remain eligible for EIC, but receive a reduced amount. This circumstance is likely attributable to the fact that EIC eligibility is mostly

⁴¹ The percentage of taxpayers retaining some EIC is 47.6 percent for taxpayers who were represented compared with 27.4 percent retaining some EIC for taxpayers without representation. The difference between unrepresented and represented taxpayers is statistically significant at level .01 (one-sided t-test).

⁴² This “No Change” rate includes taxpayers who actually received additional EIC as a result of the audit. This includes 0.35 percent overall of unrepresented taxpayers and 1.0 percent overall of represented taxpayers.

based on hard and fast rules regarding a child's relation to and residency with a taxpayer. Accordingly, little middle ground remains for a partial allowance of EIC, underscoring the importance of the IRS reaching a correct audit determination.

CHART 3, Impact of Representation on EIC Allowed During Audit



Source: IRTFTY 2004 & CAF for TY 2004

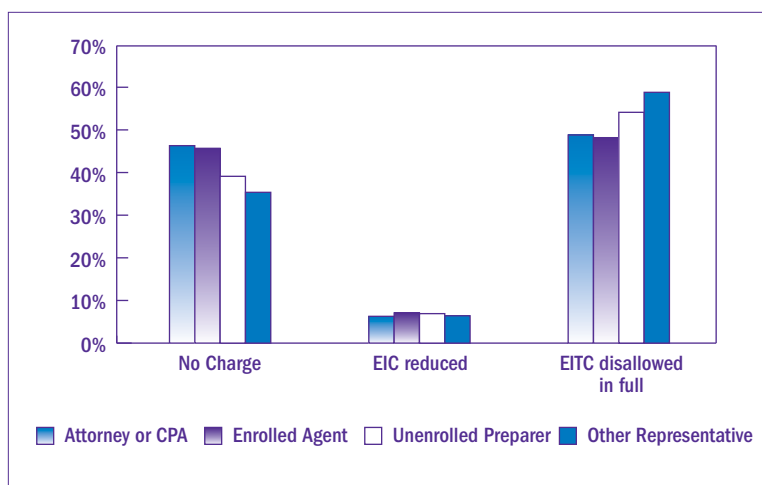
The type of representative also has an impact on the change in the amount of EIC received, as shown in the following Table 6. Nearly 46 percent of taxpayers represented by attorneys and CPAs retain the full amount of their EIC claim. Taxpayers represented by generally less sophisticated unenrolled preparers retained EIC for their clients only 39 percent of the time. This finding implies that representatives with more training are better able to successfully represent their clients and suggests that minimum standards should be considered to enable a representative to practice before the IRS. Nevertheless, it should be noted taxpayers using representatives with fewer credentials still achieve considerably more favorable results than taxpayers without representation.

IRS Earned Income Credit Audits — A Challenge to Taxpayers

TABLE 6, EIC Retained/Disallowed During Audit by Type of Representative

	Attorney or CPA	Enrolled Agent	Unenrolled Preparer	Other Representative ⁴³	Total ⁴⁴
Count	2,356	1,452	2,139	1,407	7,354
Percentage of taxpayers with no change in EIC ⁴⁵	45.8%	45.1%	38.9%	35.4%	41.7%
Percentage of taxpayers whose EIC was reduced	5.7%	6.9%	6.8%	5.5%	6.2%
Percentage of taxpayers whose EIC was disallowed in full	48.5%	48.0%	54.3%	59.1%	52.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: IRTF TY 2004 & CAF for TY 2004

CHART 4, EIC Retained/Disallowed During Audit by Type of Representative

Source: IRTF TY 2004 & CAF for TY 2004

⁴³ The “Other Representative” category includes fulltime employees (officers) of the taxpayer’s organization, family members, enrolled actuaries, law students and accounting students.

⁴⁴ Excludes 334 audited returns where the type of representative could not be determined from IRS data.

⁴⁵ This “No Change” rate includes taxpayers who actually received additional EIC as a result of the audit. Overall, 0.35 percent of unrepresented taxpayers and 1.0 percent of represented taxpayers received additional EIC.

Objective 2: Determine if taxpayers with representation in EIC audits retain a greater proportion of the EIC originally claimed than taxpayers without representation in EIC audits.

Finding: Represented taxpayers retain more of their EIC.

The prior section focused on the percentage of taxpayers whose EIC was reduced or remained the same. Another way to analyze the data is to look at the percentage of EIC dollars retained. Table 7 below shows that taxpayers with representation retained, on average, 45 percent of their EIC versus 25 percent for taxpayers without representation.

TABLE 7, Portion of EIC Retained During Audit

	Not Represented	Represented
Average percentage of original EIC retained	25.3%	44.8%

Source: IRTF TY 2004 & CAF for TY 2004

As in the prior section, taxpayers using representatives with more credentials had more favorable outcomes. Table 8 shows that taxpayers who used an attorney or CPA retained 49 percent of their EIC during the audit, almost seven points higher than unenrolled preparers and over ten percentage points higher than for other representatives.

TABLE 8, Portion of EIC Retained During Audit by Type of Representative

	Attorney or CPA	Enrolled Agent	Unenrolled Preparer	Other Representative	Total ⁴⁶
Count	2,356	1,452	2,139	1,407	7,354
Average percentage of original EIC retained	49.2%	48.8%	42.4%	38.3%	44.8%

Source: IRTF TY 2004 & CAF for TY 2004

The number of qualifying children is one of the key determinants of the amount of EIC to which a taxpayer is entitled. Table 9 shows that represented taxpayers retain a significantly greater share of their EIC for claims with children. Interestingly, unrepresented taxpayers fared better than represented taxpayers for EIC claims without children; however, these no children EIC claims accounted for less than one percent of the audited EIC claims.⁴⁷

⁴⁶ Excludes 334 audited returns where the type of representative could not be determined from IRS data.

⁴⁷ No children EIC audits in this study population included 556 unrepresented taxpayers and eight represented taxpayers.

TABLE 9, Portion of EIC Retained During Audit by Qualifying Children

	Not Represented	Represented
No Qualifying Children	53.9%	46.5% ⁴⁸
One Qualifying Child	23.7%	43.3%
Two Qualifying Children	26.4%	45.8%

Source: IRTF TY 2004 & CAF for TY 2004

Another consideration is the impact a given change has on the taxpayer. For example, perhaps the 45 percent of EIC retained by represented taxpayers is offset by the absolute amount of the reviewed credit, because taxpayers without representation have higher claimed amounts. In other words, disallowing in full an EIC of \$100 will have less effect on a taxpayer than reducing a \$4,000 credit by half.

Table 10 shows the averages for EIC received, changed, and net final amount. The first observation we can make is that represented and unrepresented taxpayers have similar before-audit EIC amounts, a difference of \$36. Second, the average EIC disallowed is \$587 higher for not represented taxpayers. The overall result is that taxpayers with representation retain \$623 more than taxpayers without representation, even though the initial difference is only \$36.

TABLE 10, EIC Amount Before and After Audit⁴⁹

Average EIC Amount:	Not Represented	Represented	Difference (Rep.- Not Rep.)
Before audit	\$2,981	\$3,017	-\$36
Disallowed during audit	\$2,250	\$1,663	-\$587
After audit	\$731	\$1,354	\$623

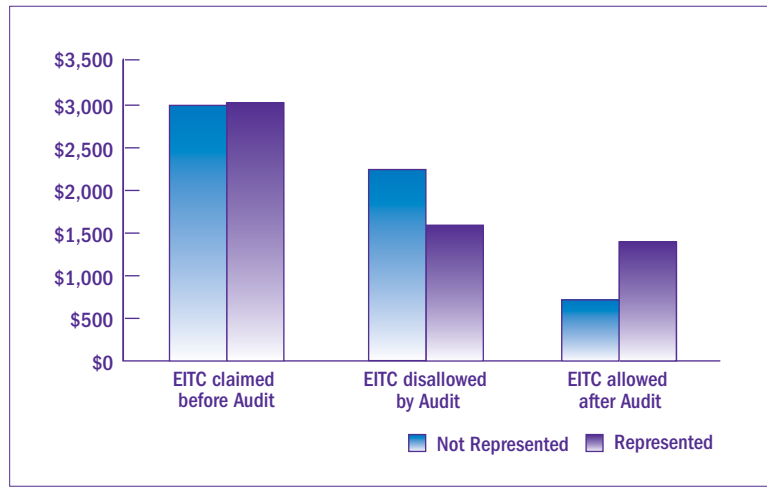
Source: IRTF TY 2004 & CAF for TY 2004

In summary, represented taxpayers retain more of their EIC in both percentage and absolute dollars than taxpayers without representation.

⁴⁸ These taxpayers received more EIC after audit than originally allowed by IRS after return processing.

⁴⁹ The difference between unrepresented and represented taxpayers is statistically significant at level .01 (one-sided t-test).

CHART 5, Amount of EIC Before & After Audit



Source: IRTF TY 2004 & CAF for TY 2004

TAS also wanted to examine what happens to taxpayer accounts in the post-audit period. Several occurrences may cause a taxpayer’s EIC to be adjusted after the conclusion of an audit. The taxpayer may request the IRS to reconsider audit findings based on other information that could not be made available at the time of the audit. Taxpayers may also pursue administrative and legal remedies to disagree with audit findings, and the results of these proceedings may not adjust a taxpayer’s EIC until after the close of the audit case. The following table compares after audit results for represented and unrepresented taxpayers for TY 2002.

TABLE 11, EIC Retained/Disallowed After Audit⁵⁰

Percentage of Taxpayers with:	Not Represented	Represented
Some EIC Restored	77.8%	94.8%
No EIC Restored	22.2%	5.2%
Total	100.0%	100.0%

Source: IRTF TY 2002 & CAF for TY 2002

Table 11 shows that represented taxpayers were significantly more likely than their unrepresented counterparts to have EIC restored for TY 2002 during the after audit period.

Similarly, Table 12 below shows that the represented taxpayers also have a significantly larger amount of EIC allowed in the after audit period when compared to those taxpayers without representation.

⁵⁰ Includes only cases with an EIC adjustment after audit. Ninety-nine of these cases were Appeals or Tax Court cases. An additional 171 Appeals and Tax Court cases are not represented in this table because the administrative appeal or litigation resulted in no after audit change to EIC.

TABLE 12, EIC Dollars Allowed After Audit

Average EIC Allowed After the Audit	Mean
Not Represented	\$1,320.46
Represented	\$2,286.03

Source: IRTF TY 2002 & CAF for TY 2002

Objective 3: Determine if the tax recommended for taxpayers with representation in EIC audits is less than the tax recommended for taxpayers without representation in EIC audits.⁵¹

Finding: Fewer represented taxpayers owe additional tax.

The prior findings focus on the impact of representation on the EIC. There may be other issues addressed during an audit in addition to the EIC. In this section, we investigate the impact of representation on the net tax resulting from the audit.

The average amount of additional tax due after audit for both unrepresented and represented taxpayers is similar, as shown in Table 13 below. Nevertheless, there are significant differences in the percent of taxpayers within these two groups who actually owe additional tax. Over 71 percent of the represented group owed *no* additional tax, while almost 41 percent of unrepresented taxpayers *owe* additional tax at the conclusion of the audit.

TABLE 13, Tax Change During Audit⁵²

Percentage of taxpayers:	Not Represented	Represented
whose tax increased during audit	40.8%	22.6%
with no change in tax during audit	53.1%	71.7%
whose tax decreased (refund) during audit	6.1%	5.7%
Average Tax Change (increase) during audit	\$210	\$133

Source: IRTF TY 2004 & CAF for TY 2004

The one positive result for unrepresented taxpayers is that a slightly higher percentage of them received a reduction in tax due compared to represented taxpayers. However, this needs to be considered in combination with the greater share of unrepresented taxpayers (41 percent) who pay additional tax.

⁵¹ This objective focuses only on tax change which is separate from changes in refundable credits such as EIC.

⁵² The difference between unrepresented and represented taxpayers is statistically significant at level .01 (one-sided t-test).

Conclusions

- The IRS struggles with effectively communicating with taxpayers during EIC audits.
- Generally, taxpayers are trying to comply with IRS requests for information and documentation.
- Given that over 90 percent of respondents reported contacting the IRS about their audit, with close to 30 percent contacting IRS more than once, IRS' poor communications place a *burden* on taxpayers and on limited IRS resources.
- IRS requests EIC taxpayers provide proof for several complicated eligibility factors, and the taxpayer often does not understand how the verification documentation requested by the IRS will prove EIC eligibility.
- Many taxpayers question whether the IRS considers all submitted documents, and, in turn, whether the IRS reached the correct determination regarding their EIC eligibility.
- Taxpayers who use representatives are nearly twice as likely to be found eligible for the EIC as compared to taxpayers who are not represented during the audit process.
- Over 40 percent of all taxpayers with representatives emerged from their audit with their full EIC intact, whereas less than 1 in 4 taxpayers without a representative kept their full EIC.
- The taxpayers without representation were more likely to end up owing additional *tax* than taxpayers with representation (41 percent versus 23 percent).
- The barriers reported by taxpayers from their experiences with the IRS EIC audit process are likely important factors in why taxpayers who obtain representation during their EIC audit have significantly more favorable audit outcomes.
- The vast majority of taxpayers who undergo an EIC audit do not have representation and the number of taxpayers with representation during the EIC audit declined significantly from TY 2002 to TY 2004.

Recommendations

The following recommendations are based on study findings.

- Increase taxpayer awareness of the legal assistance available at Low Income Taxpayer Clinics (LITCs).
- Ensure all correspondence during the EIC audit provides taxpayers with references for contacting a LITC.
- Inform taxpayers of the closest LITC. Since these locations change annually, taxpayers could be instructed to call TAS if the LITC is no longer participating in the program.
- If a taxpayer cannot provide all requested documentation to verify EIC eligibility, and the IRS has no information to dispute the EIC claim, allow the taxpayer to provide an affidavit from an IRS approved source to prove EIC eligibility.

- Assign one worker to each EIC audit. Provide the worker's name, phone number, and address in all correspondence with the taxpayer.
- Call taxpayers, whenever possible, to see if verbal communication can resolve any miscommunication.
- Revise EIC audit letters. Letters should be written to address the taxpayers' personal tax return and should specifically state that the taxpayers' tax return is being audited. The letters should clearly list the specific issues of the audit and explain what the taxpayer must do to resolve each issue, and should also explain how the documentation relates to the issue in question.
- Provide timely acknowledgements to all documentation and materials received from the taxpayer.
- Inform taxpayers of the right to a face-to-face audit and what steps must be taken to request the audit be changed to face-to-face.
- Provide a checklist that taxpayers can use to guide them in securing the proper documents and steps needed to validate their eligibility.

Annual Report to Congress

National Taxpayer Advocate

2007 Annual Report to Congress

SIMULATING EITC
FILING BEHAVIORS:
VALIDATING AGENT BASED
SIMULATION FOR IRS ANALYSES:
THE 2004 HARTFORD CASE STUDY

Annual Report to Congress

2007

Annual Report to Congress

Simulating EITC Filing Behaviors: Validating Agent Based Simulation for IRS Analyses: The 2004 Hartford Case Study

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1 September, 2007

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Executive Summary

The IRS Office of Program Evaluation and Risk Analysis (OPERA) initiated a research program in 2004 to explore the feasibility of using multi-agent (agent based) simulations to help inform decision making about how to more effectively and efficiently administer the US tax system. This program is being conducted under the sponsorship of the National Taxpayer Advocate, and is part of a research effort originally initiated in 2003 at the request of the National Taxpayer Advocate to explore the applicability of a variety of technologies to understanding the dissemination of abusive tax schemes. The Office of the National Taxpayer Advocate expressed interest last year in exploring the applicability of this type of simulation for supporting other analyses. The National Taxpayer Advocate's interest centered on increasing confidence in the validity of the simulation for representing subsets of the population that are of high interest to the Taxpayer Advocate. To accomplish this, the National Taxpayer Advocate requested that the simulation team attempt to replicate an actual tax related event that occurred in the US population. The specific request was to recreate the IRS EITC Certification study experience in Hartford County, Connecticut, for tax year 2004.

The project, executed by the research team at Carnegie Mellon University, achieved the following three goals:

- Goal 1:** Demonstrated the ability to represent the diverse types of events that occur in a complex social environment in the Construct simulation.
- Goal 2:** Demonstrated the ability to “tune” the Construct simulation to reasonably approximate a real world experience.
- Goal 3:** Examined via the Construct multi-agent simulation the relative impact of the diverse events that actually occurred as compared to other sequences of events that might have occurred (counterfactuals).

Demonstrating achievement of the first goal, the simulation was able to represent a set of key events and agent behaviors that provided insight into the filing behavior of the target population. That said, the insights were more immediately visible to the simulation development team. Some key observations relating to this goal are that nontrivial simulation development was required to provide the functionality necessary to represent this scenario. Taxpayer agents needed to be parameterized differently for this effort than for previous phases. The lessons of this experience are informing the evolving design of the taxpayer agents and the simulation overall. The representation of targeted notices sent to taxpayer agents meeting specific demographic criteria identified necessary functionality for understanding how changes to IRS notice programs will affect taxpayer behavior. Implementing this very precise type of communication into a multi-agent simulation was a nontrivial challenge. This required the pursuit of some advances to the state of the art in multi-agent simulation and consumed significant resources. That said, this advanced functionality was successfully implemented and is available for use in future Virtual Experiments.

The second goal to tune the simulation to appropriately match the Hartford experience emphasized comparative evaluation of the event sequences, population description and behaviors, and event timing. All three of these dimensions were successfully tuned, or matched to the Hartford experience. The accompanying table illustrates the match that was achieved with the EITC Study population as reflected in the 2007 Study.

Characteristic	EITC Study Population	Simulated Population
Percent don't file a return	0.12	0.15
Percent file a return	0.88	0.85
Percent claim EITC with children	0.58	0.62
Percent claim EITC with one child	0.31	0.35
Percent claim EITC with two child	0.27	0.27
Percent file a return and single	0.19	0.20
Percent file a return and married	0.06	0.04
Percent file a return and head of household	0.75	0.76
Percent file a return and male	0.59	0.60
Percent file a return and female	0.41	0.40
Percent file a return and under 31	0.37	0.39
Percent file a return and 31-40	0.29	0.27
Percent file a return and 41-50	0.23	0.23
Percent file a return and over 50	0.11	0.10

It is important to note that the data do not match perfectly. This is by design. It would be possible to force the simulation to match every parameter perfectly. However, that tightly controlled level of specification would then constrain the ability of the simulation to naturally change in response to changes in the independent variable(s), rendering it invalid for use in Virtual Experiments.

The third goal, to examine via a virtual experiment the relative impact of diverse real-world events on the multi-agent simulation, demonstrated that the simulation was capable of consistently generating results that closely approximated many of the response measures across several possible situations.

Introduction

The IRS Office of Program Evaluation and Risk Analysis (OPERA) initiated a research program in 2004 to explore the feasibility of using multi-agent (agent based) simulations to help inform decision making about how to more effectively and efficiently administer the U.S. tax system. The research effort is focusing on enhancing the functionality of an existing simulation, called Construct, to represent explicitly the key tax related beliefs, knowledge, decisions, and behaviors of taxpayers; as well as the diffusion of tax related information around a city sized population. The initial simulation development efforts provided encouraging results that were reported to the Service research community in June of 2006. (Carley & Maxwell, 2006)

The Office of the National Taxpayer Advocate is sponsoring this research. The National Taxpayer Advocate expressed interest in increasing confidence in the validity of the simulation for representing subsets of the population that are of high interest to the Taxpayer Advocate. To accomplish this, the National Taxpayer Advocate requested that the simulation team attempt to replicate an actual tax related event that occurred in the US population. The specific request was to recreate the IRS EITC Certification study experience in Hartford County Connecticut for tax year 2004.

The project had three major goals. Specifically:

- Goal 1:** Demonstrate the ability to represent the diverse types of events that occur in a complex social environment in the Construct simulation.
- Goal 2:** Demonstrate the ability to “tune” the Construct simulation to reasonably approximate a real world experience.
- Goal 3:** Examine via the Construct multi-agent simulation the relative impact of the diverse events that actually occurred as compared to other sequences of event that might have occurred (counterfactuals).

These goals were accomplished over a period of approximately 120 days by the research team at Carnegie Mellon University’s Center for the Analysis of Social and Organizational Systems (CASOS). Some additional simulation functionality was added to the simulation to represent the specific filing decisions associated with EITC and with the behaviors of opinion leaders in a community.

The effort and its results are described in the sections that follow. The next section provides a short description of the Hartford scenario, with emphasis on the factors that were most relevant for informing the simulation effort. We then describe the key characteristics of the Construct simulation, highlighting the behaviors that are relevant to simulating the key events in Hartford. This section is responsive to Goal 1 above. After the scenario and the simulation are described, we report the results of the successful simulation tuning effort; documenting achievement of Goal 2. The next section describes a demonstrative “Virtual Experiment” that was conducted using the simulation. This experiment explores

counterfactual situations, or what might have happened if the events in Hartford had unfolded differently, satisfying Goal 3. Finally, we will conclude with a set of conclusions and recommendations that address simulation development and the role multi-agent simulation might play in supporting Service decision making.

The Hartford Scenario

The IRS has a long term ongoing and multi-faceted program initiative that is attempting to ensure fairness and compliance in the administration of the Earned Income Tax Credit (EITC). One of the initiative's goals is to reduce EITC over-claims without adversely affecting participation among eligible taxpayers. The tax year 2004 report in support of this initiative documents a qualifying child certification test that was conducted in Hartford County Connecticut between November 2004 and December 2005. (IRS, 2007).

The scenario began unfolding when information of the test reached the mayor of Hartford City in early November 2004; that information triggered a series of events that influenced the certification and filing behavior of the city's (and likely some county) residents. For purposes of our analysis these events are information that is communicated to the potential EITC population that influences their decisions. There are five key "information" events in the simulated scenario:

- Hartford City mayor announces IRS agrees to three-week delay in targeted IRS review of Hartford taxpayers.
- November 28, 2004 – IRS sends first notice to selected taxpayers;
- November 29, 2004 – Hartford City sues IRS;
- January 5, 2005 – IRS reminder notice sent to those that did not certify;
- January 31, 2005 – Hartford City mayor launches EITC tax preparation program.

These events are analytically interesting because they represent a set of mixed messages; some encouraging taxpayers to comply with the program and some discouraging compliance. They become even more interesting because both sets originate from authoritative sources (called opinion leaders in the simulation) and the mayor's message changes tone over time.

The test group consisted of 8041 taxpayers who were EITC claimants in Hartford County by April 15, 2004, and who claimed qualifying children in 2003 that could not be verified. This part of the population is identified in figure 1 inside the smallest ellipse. There are two other segments of the population that are relevant to our analysis. First, there are 47,000 taxpayers in Hartford County that are similar to the test group, with the exception that in the prior year they did not claim qualifying children, or the eligibility of the claimed children was verified by the IRS. The outer ellipse completes the county population identifying the high income taxpayers. The focus of the analysis are the regions of the population that includes the ellipses showing the general EITC population and

the 8,041 taxpayers. Another analytically interesting feature of the Hartford County population is the distribution of taxpayers between the city of Hartford and the remainder of the county. This is represented by the horizontal ellipse. This geographic distribution is especially important for two reasons. First, the initial opposition to the certification test originated with the mayor of the city. So he is a formal opinion leader for only a subset of the population. Second, the density of EITC claimants as a proportion of the total population would be expected to be higher in the city compared to the remainder of the county based on the demographic data that is available.

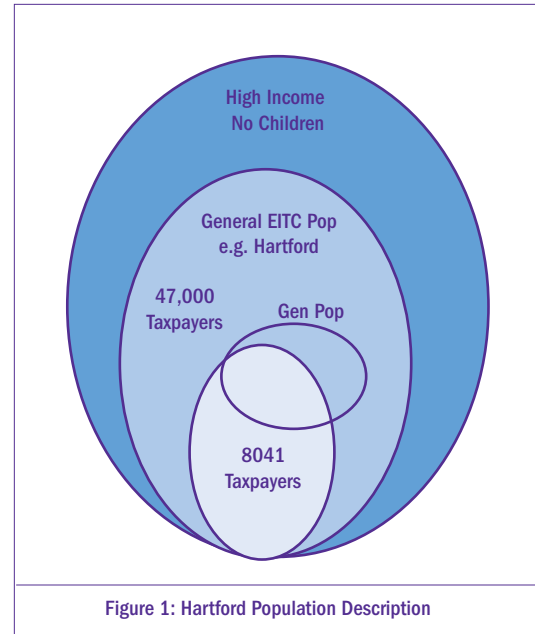


Figure 1: Hartford Population Description

Within the population of interest it is important to gain a more highly resolved understanding of the population. This detail is what allows analysts and simulation developers to increase the fidelity of a simulation. More importantly this increased resolution better matches the types of decisions about how to support and respond to diverse populations Service executives face in administering the tax system. In our case the data from the FY 05 report indicates that our population of interest has the following key characteristics:

- Filing Status (Married – three percent, Female – 37 percent, Male – 60 percent);
- Income (0-15K — 42 percent, 15-30K — 38 percent, 30-35K — 20 percent);
- Age (0-29 — 34 percent, 30-39 — 29 percent, 40-49 — 23 percent, 50+ — 14 percent);
- Paid preparer use (72 percent of all taxpayers without children, 76 percent of EITC with qualifying children eligible taxpayers).

Simulation Description

CASOS' Construct simulation has been richly developed and applied to numerous social science related research projects and governmental analyses over the past decade. A complete description of the simulation is beyond the scope of this effort, but a very complete reference is Schreiber & Carley (2004). Efforts to effectively represent taxpayer (agent) behaviors and collect outcome data that are relevant to tax administration have been underway for some time. So, there is an existing set of relevant behaviors and measures of effectiveness that provided a foundation for this effort. These are described in Carley & Maxwell (2006) and the interested reader is referred to that source for more complete information.

Multi-agent simulations consist of a few key parts that we will describe briefly here in the context of the Hartford test. First, there is a population of agents that interact with each other in a simulated environment. Second, each agent possesses characteristics, or attributes, that give it an identity in the population of agents. Third, the agents have a set of beliefs, knowledge, and behaviors that reflects how they interact with other agents, as well as key actions they will perform. The set of behaviors available to an agent is a function of its attributes. And finally, there is a set of outcome measures that are collected reflecting the status of key variables in the simulation. (e.g. number of rejected EITC claims).

The scenario being modeled runs over a period of one year. It begins immediately following the April 15th filing deadline in 2004 and runs through the Tax year 2004 filing deadline April 15th 2005. The simulation is a time stepped model, with each time step representing one week on the calendar.

The Construct **taxpayer agent population** for this effort consisted of 3218 agents that represent the EITC population of Hartford County. Fifty percent of the agents (1609) were assigned attributes consistent with the study population, and the other half represented the remainder of Hartford's General EITC population. This distribution of agents that emphasizes the study population as a percentage of the total implements a design technique called matched sampling (Rubin, 2006). We will assume for the purposes of this analysis that all of the agents "know of" the existence of EITC.

There are also two special types of agents in this scenario. The **Mayor of Hartford** is represented explicitly as an agent that broadcasts messages to multiple agents. And, the **IRS notices** to the study group were also represented as a special type of agent that interacts with taxpayer agents meeting specific criteria, and a history of the interactions is maintained. Implementing the IRS notices required some significant enhancements to the simulation software. This was necessary to ensure that initial notices were sent with certainty to the correct subset of the taxpayer agent population. Still more enhancement to the software was required to ensure that follow up notices were sent with certainty only to taxpayer agents that received an initial notice and did not respond to the first notice.

The taxpayer agents are described by six attributes that were identified by IRS experts as relevant to understanding the behavior of the general EITC population, as well as informative for cross classifying the agents inside the broader population. These are:

- Filing Status – Married, Unmarried Female, Unmarried Male;
- Preparation – Unpaid or Paid;
- Age – 0-29, 30-39, 40-49, 50+;
- Income – 0-15,000, 15,001-30,000, 30,001-36,000;
- Children – 0,1,2+; and
- Locale – Hartford County, Hartford City.

These characteristics are assigned to each agent so that the population is consistent with the demographics as they are described by census data, and the parameters of the sample matching process. The preparation data was provided by the EITC 2005 study, with 72 percent of the population without children and 76 percent of those with children using a paid preparer.

TABLE 1, Relevant Facts and Beliefs

Facts Associated	Category
1	Know of EITC (Knowledge)
10	How to claim EITC (Knowledge)
12	How to certify for EITC (Knowledge)
1	Know of certification process (Knowledge)
6 (3 yes 3 no)	Eligibility belief (Belief)
7 (4 yes 3 no)	Certification belief (Belief)

All of the agents in the simulation possess facts and beliefs. These are a binary representation where a 0 reflects the absence of a belief or fact and a 1 indicates it is present. As concepts get more complicated they possess more potential facts or beliefs. Table 1 illustrates the key facts and beliefs that are relevant for this scenario.

A simulation run extends over 52 weeks, with each simulation time period equal to one week. There are two types of events; external events that are scripted into the scenario, and taxpayer events that potentially occur at each time step based on the agents' current knowledge and beliefs. There are five possible external events in the simulation occurring at specified times. The calendar dates, event, and simulation time period are identified below.

- November 8, 2004 – First anti IRS message from the mayor – time-period 29;
- November 28, 2004 – Initial IRS soft notice sent – time-period 32;
- November 29, 2004 – Second anti IRS message from the mayor – time-period 32;
- January 5, 2005 – IRS reminder notice – time-period 37;
- January 31, 2005 – First pro IRS message from the mayor – time-period 41.

In addition to the scripted events, the agents have a set of behaviors that may (or may not) occur at each time step. There is a base set of behaviors where they communicate with other agents, as described in the cited Construct foundation literature. The set of custom behaviors that was designed and implemented for the EITC project follows:

- Receive first IRS soft notice;
- Receive second IRS soft notice;
- Listen to Mayor;

- Decide to get certified;
- Get certified;
- File & claim EITC; and
- File & don't claim EITC.

Each of these behaviors has a set of unique characteristics that are worthy of exploring in a little more detail.

Taxpayer notices from the IRS are sent with certainty to the specified study population. Once they get the notice, it is read with a very small probability. When the notice is read the agent can randomly learn up to fifty percent of the content. If the notice is not read, the likelihood that it will be read in subsequent time steps decays exponentially. Notices can be read multiple times, with the exponential decay function reinitializing each time it is read. This simulation functionality was tested, and showed significant impact on the counterfactual scenarios in the virtual experiment.

The messages from the Mayor are communicated to multiple agents. The behavior of any one agent will then depend on which messages are received from the mayor, what other information the agent has received, and the rest of its descriptive variables.

The decision to certify is influenced by a set of factors that is defined by the agents' initial beliefs and the information they receive over the course of the simulation scenario. The specific factors involved are:

- They are subject to social influence – others tell them to or not to certify;
- They believe they are eligible;
- They believe the IRS will freeze their refund and force them to prove eligibility; and
- They have information about certification.

Once the decision is made to certify, the taxpaying agent is successful 75 percent of the time in receiving certification. This event is random and at a rate that is consistent with the data provided in the 2005 study.

The two potential filing decisions identified imply a third possibility. The agent might choose not to file. It turns out that this behavior choice for this subset of the taxpaying population is over ten percent. The decision not to file could be because the taxpayer had a change in status that eliminated the need to file (a compliant decision), or the taxpayer could be choosing to become noncompliant.

There are two different sets of behaviors and decision criteria in the simulation associated with claiming EITC when filing: self prepared and paid preparer. In order for self preparer agents to claim EITC on their returns conditions 1 and 2 must be met, and either 3 or 4 or 5 must be met.

1. **Know of the EITC**

- ◆ Mark 1 fact as representing that the credit exists
- ◆ Agent knows that fact

2. **Have Sufficient How To Facts to participate in EITC**

- ◆ Agent knows 50 percent of the how to facts associated with the credit
- ◆ Complex - credit is 12 facts

3. **Random decision to participate**

- ◆ Ultimately to be related to risk taking behavior
- ◆ Ultimately to be related to other psycho-socio factors

4. **Believe they should claim the EITC**

- ◆ Based on 6 makes sense facts – 3 suggest to engage, 3 to not engage
- ◆ Belief > threshold for engagement

5. **Believe they are eligible for EITC**

If the agent uses a paid preparer the simulation logic for claiming EITC is as follows:

- Claims the EITC for the agent
- Knows of EITC and claims it
- If agents think they are eligible then so does the preparer
- Mis-claims are based on the 2005 study data

Simulation Calibration

The process of tuning a multi-agent simulation model, also called calibration, has a long tradition in the modeling community. Model tuning is the process of adjusting a computational model to reflect the features of empirical data (Carley 1996). The empirical data is historic in nature and provides the foundation for a case study comparing and contrasting what was observed with the simulation results. The result of tuning is a set of model parameters that best represent one instance of the phenomena of interest. This provides a conceptual reference point for validation, analysis, and interpretation of the computational model. Successfully tuning a model demonstrates that it is sufficiently rich to capture the behavior observed in the past, and that it is likely to be sufficiently accurate that it can be used to draw conclusions about similar behavior in the future assuming that there are no major changes in the environment (*e.g.*, change to a Value Added Tax system).

Tuning or calibration is the second in a series of validation steps going from face validity (it feels right) to accurate predictions (x number of people will file with this error in this city in this year), that are consistent with all of the uncertainties that might influence the

outcomes of interest. The issue with respect to validation is not whether a model is valid, but to what degree.

Model validation should always be done with an analytic purpose in mind. Although models are routinely criticized for lack of realism, in point of fact the level of realism and therefore the associated level of validation should be chosen to match the intended purpose of the model. For most purposes, particularly when the use of the model is to think through the basic policy issues, tuning to a level sufficient for generating credible interval measures that compare and contrast the independent variables in a Virtual Experiment (VE) is consistent with the purpose of the model.

The process of tuning a model involves data analysis of virtual and real data, parameter adjustment, repeated execution of virtual experiments, and sometimes, simulation software development. For this study we had three key types of real empirical data that the model was “tuned” to: 1) event sequences such as when opinion leaders did what; 2) population level results on the percentage of agents (taxpayers) that claimed EITC with children in the study and control group; and 3) the timing of filing over the calendar year. Each of these data required a different set of procedures for tuning.

Sequence data. To tune to sequence data we verified that the events in the sequence could be represented in the Construct simulator, and that the ordering of the modeled events matched the real world. The result was that the timing of key opinion leader events could be specified using existing functionality and no changes needed to be made to the code to represent the ordering of the events. Small changes to simulation software were needed to represent the positive messages of the opinion leader. To test whether the events as modeled impacted the outcome, we went beyond standard tuning and ran a series of counterfactuals to examine the impact of these events in the simulation and then assessed their plausibility.

Population data. To tune based on the population data we first used generic population fractions and set up the model. Then we compared the results with the study and control groups. In general, participation was too low in the study group. This was due to the different socio-demographics in the study group. We then adjusted the agent population to match those socio-demographics. The result was that the model was able to predict EITC engagement in the study and control groups comparable to that observed. The results can be seen in a later section of this report.

Filing Timing data. To tune to this data we actually needed to create an entirely new module that enabled the simulated taxpayers to file early. Tuning did provide timing distributions qualitatively similar to the filing patterns that were observed for the EITC general population. However, the distributions are still off quantitatively. Through a series of virtual experiments, we discovered that this is due to a lack of reasoning in the agents for choosing when to file.

Table 2 highlights a comparison of the key descriptive attributes of the EITC study population and its behavior with the corresponding factor in the simulated population. The biggest inconsistency that was observed was in the percentage of the population that is claiming the EITC with one child (and so the sum with children). This inconsistency appears to be due to the different, and somewhat inconsistent, sources of data that inform the formulation of the virtual population; the combination of census and IRS data. Virtual experiments indicated that this deviation did not adversely affect the ability to comparatively analyze the different options represented in a virtual experiment.

TABLE 2, Comparison of Key Descriptive Attributes of the EITC Study Population with the Simulated Population

Characteristic	EITC Study Population	Simulated Population
Percent don't file a return	0.12	0.15
Percent file a return	0.88	0.85
Percent claim EITC with children	0.58	0.62
Percent claim EITC with one child	0.31	0.35
Percent claim EITC with two child	0.27	0.27
Percent file a return and single	0.19	0.20
Percent file a return and married	0.06	0.04
Percent file a return and head of household	0.75	0.76
Percent file a return and male	0.59	0.60
Percent file a return and female	0.41	0.40
Percent file a return and under 31	0.37	0.39
Percent file a return and 31-40	0.29	0.27
Percent file a return and 41-50	0.23	0.23
Percent file a return and over 50	0.11	0.10

Recall that the design of the virtual environment is called a matched sample, and that the actual numbers of agents in the simulated study population and control group were equal even though they were not the same size population. That said, the simulation was able to produce behaviors and results that were largely consistent with both the study group and the control group. Just as importantly the minor inconsistency in filing status that was observed between the study population and its corresponding virtual population is similarly observed between the control group and its corresponding virtual population. This is a very positive indicator with respect to the validity of the simulation for the Virtual Experiment in this demonstrative study.

EITC Virtual Experiment

The virtual experiment uses the customized multi-agent simulation to predict responses under several conditions that represent the real-world events in Hartford City, Connecticut in 2004 and 2005. The five key “information” events in the simulated scenario are:

- November 8, 2004 – Hartford City mayor announces IRS agrees to three-week delay in targeted IRS review of Hartford taxpayers;
- November 28, 2004 – IRS sends first notice;
- November 29, 2004 – Hartford City sues IRS;
- January 5, 2005 – Reminder notice sent to those that did not certify;
- January 31, 2005 – Hartford City mayor launches EITC tax preparation program.

Analyzing how well the simulation can cope with these mixed-message situations and changing influences from opinion leaders is important because it indicates the simulation’s ability to handle the complex situations that arise in the real world.

Several sets of events were developed, designed to represent the events at key time-periods over the 2004-2005 year, and five replications (runs) of the simulation were applied to each:

Case 1: No intervention events occurred.

Case 2: IRS First Notice: The IRS sent out a first notice.

Case 3: IRS Reminder: The IRS sent out a first notice followed by a reminder.

Case 4: Negative Mayor: The IRS sent out a first notice followed by a reminder, and the mayor communicated a negative opinion and then followed this with a second negative opinion. The mayor’s messages are negative relative to the IRS.

Case 5: Most Realistic: The IRS sent out a first notice followed by a reminder, and the mayor communicated a negative opinion followed by a switch to a positive opinion. The positive opinion message by the mayor is simply less antagonistic to the IRS than the negative message, and does encourage taxpayers to talk to tax assistance centers. This case is closest to what actually happened.

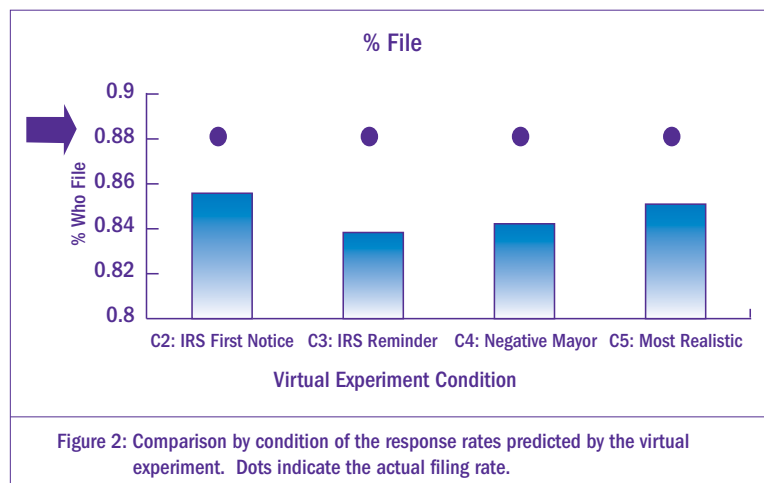
Case 6: The IRS sent out a first notice followed by a reminder, and the mayor communicated a positive opinion.

Case 7: The IRS did not send out a first notice or reminder and the mayor communicated a positive opinion.

Case 8: The IRS did not send out a first notice or reminder and the mayor communicated a negative opinion.

In general, the virtual experiment indicated that the simulated actions did not significantly affect whether people filed a return. Figure 2, below, demonstrates this result. Each bar in

the graph shows what percentage of people filed a return under each simulated condition. The last column represents the simulated conditions which most closely approximate what really happened. This corresponds to Case 5, in which the IRS sent out a first notice followed by a reminder, and the mayor communicated a negative opinion followed by a switch to a less-negative, *i.e.* a positive opinion. Additionally, for comparison, the dots in Figure 2 indicate the actual percentage of EITC study participants who filed a return. The percent who file predicted by the virtual experiment is a little low across all conditions, but differences in response rate between the conditions are not significant. (Note that the Y axis contains a range of 10 percent.) The important point here is that the Construct model is suggesting that initiating the certification process, reminding study participants, and messages sent by the mayor had little impact on who filed.



The virtual experiment can also give insight into the possible deterrence effect of certification and the activities of the IRS and the Mayor on the response rate of the EITC study population for a particular variable. Figure 3, below, illustrates this for the percent who claimed EITC with children in the simulated and real study group.

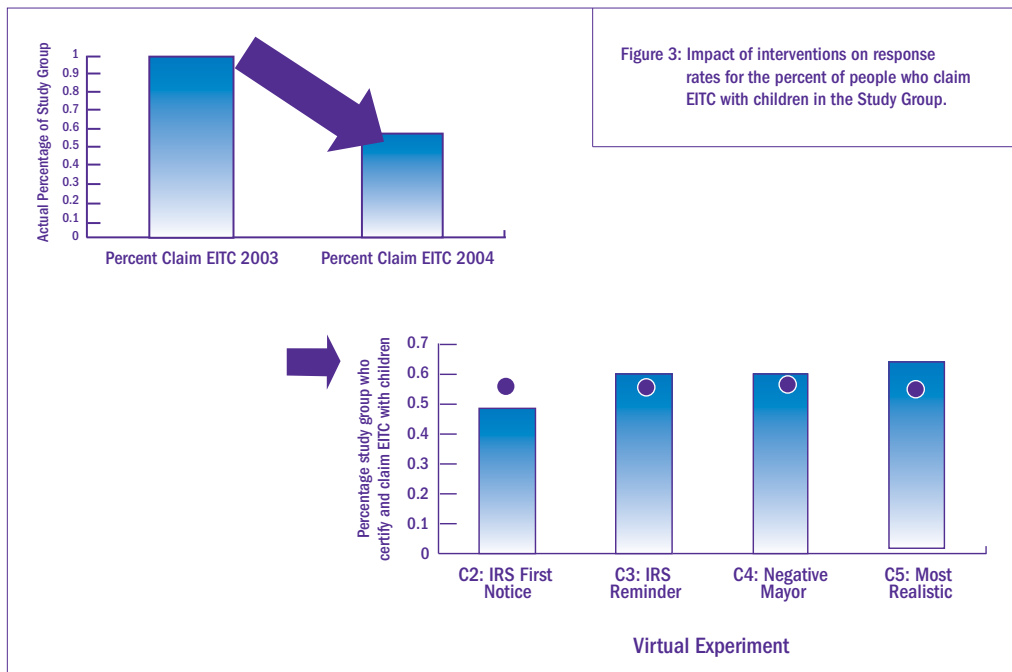
In the actual study group there was a drop in the response rate for the percentage of taxpayers who filed and claimed the EITC with children from 2003 to 2004. This is indicated in Figure 3 in the top left. The arrow highlights this drop. This means that historically, only 58 percent of the study group claimed EITC with children after the certification process that started in the fall of 2004 began. It is important to note that a variety of factors, other than the certification process, might also have contributed to the reduction in claimants in the real world study group. Over the last few years the composition of the EITC population has changed by about a third on average, meaning that about one third stop claiming EITC and are replaced by new claimants.

We attempted to capture this general change in the composition of the EITC population in Construct. Several mechanisms were included. Some of the virtual agents had new

children; we used US birth rate. Some of the virtual children became too old to be eligible. We assumed a uniform distribution in age and simply “aged” the children, hence, approximately 1/18 of the families with children had one less eligible child assuming that they did not “gain” a child. We also simulated changes in custodianship that occurred due to divorce; for this we used average US divorce rate. While there are many additional factors that impact the composition of the EITC population, we found these three to be sufficient to account for most of the change. Other factors that might be considered in the future include: change in income due to job, college level children, and death rate.

These compositional changes are fixed across all virtual experiments. Consequently, since we simulated these types of changes to the composition of the population, variation in the results for cases 2 through 5 are due to the potential deterrence, or lack of deterrence effect due to the various interventions: notices, reminders, and mayoral messages.

In the bottom right of Figure 3 the comparison of what the Construct model predicts to the actual EITC claim rate shows the possible deterrence effect of certification under diverse interventions. The virtual experiment shows that across the different types of interventions, the response level was consistently close to the actual percentages, shown as dots. Similarly to Figure 2, there is little variation across conditions. Under most conditions, *i.e.*, most cases, the simulated results are comparable to what was observed in the real world with the study group. The critical exception here is that when only the IRS first notice is present the simulated results are lower than the real case and than other simulated conditions.



Top left displays the change in percentage of filers who claim EITC with children in the actual Study Group. Bottom right displays the variation in claimants under diverse interventions. The dots on the bottom right indicate the actual percentage of filers in the Study Group who claimed the EITC with children in 2004.

It is important to note that in the real data 63 percent of the control group, as opposed to 58 percent of the study group, filed and claimed the EITC with children in 2004. This may have been due to a variety of factors, such as suppression in claims in the study group or differences in composition of the study and control group. We found that, for the simulated study group in the most realistic case, the predicted number of those who would claim the EITC with children was 62 percent. Similarly, we found that for the simulated control group in the most realistic case, the predicted number of those who would claim the EITC with children was also 62 percent. Keep in mind, the difference here is that the simulated study group had a slightly different composition than it did in the real world, and the members received both the IRS first notice and the reminder; whereas, the simulated control group did not receive the IRS first notice and the reminder. In addition, the simulation of the study group who receive only the first notice, no reminder and no messages from the mayor has a significantly lower level of filing and claiming the EITC with children. This suggests that had the IRS only sent the first notice there would have been suppression in claims; however, by sending the second notice, this suppression effect was mitigated. This also suggests that the opinions expressed by the mayor may have had little impact on claims.

Conclusions and Recommendations

The success of this effort adds to a growing confidence that multi-agent simulation could be a useful tool for informing Service analyses and decision processes. In particular, the virtual experiment emphasizes the multi-agent simulation's ability to handle a variety of possible events and produce good representations of real-world responses across those different scenarios. The ability to engage in what-if analysis is particularly informing as it brings to light the relative impact of alternative interventions both by the IRS and others.

There are a number of limitations to this study, and the results should be viewed with caution. First, many factors that played a role in Hartford were not modeled. For example, the Service met with many local groups to try and help them understand the proposed certification process. This meeting and the interaction of taxpayers with these local groups was not captured. Another key limitation is that when the mayor gave his more "positive" message, it was done in the context of encouraging taxpayers to take advantage of the tax assistance centers. The role of these centers in affecting taxpayer behavior was not modeled. A third example has to do with the timing of filing. Taxpayers tend to adjust when they file based on use of a preparer, expectation of a refund, and so on. Such timing considerations were not modeled. Consequently, the impact of intervention on when taxpayers filed and when they sought certification could not be considered.

Additional research and simulation development is required to achieve a level of maturity that is consistent with operational use of the tool. Specifically, additional virtual experiments are required to develop a body of knowledge about the simulation and its behavior, as well as sufficient confidence in its validity for representing “decision relevant” scenarios. Coincident with these validation and verification (V&V) oriented experiments additional investments in simulation functionality should be planned to respond to the limitations of the simulation that will likely be identified. Added features and sub-modules, such as ones dealing with literacy, presence of tax assistance centers, and expectations for reimbursement will clearly increase the range of policy issues the model can address. However, as features are added the time it takes to use the model to generate results for various “what-if” questions increases, and the time it takes to “retune” the model to fit historic cases, such as this EITC study, increases. Consequently, investment in features should occur with investments in parallelization, scalability studies, and continual retuning of the model as new features and modules are added.

In summary, multi-agent dynamic network models in general, and Construct in particular, can play a critical role in understanding the impact of Service activity on the taxpayer. Results have sufficient fidelity that they can support meaningful policy decisions. Initial results demonstrate that such models can have sufficient fidelity to replicate historic events and sufficient flexibility to reason about alternative histories. To move from this modest beginning to an operational tool that accurately forecasts the impact of diverse interventions on taxpayer behavior is possible; but movement should proceed cautiously considering both technological challenges (parallelization) and substantive challenges (timing of taxpayer behavior). Next steps should focus on addition of features and associated validation, consideration of other types of taxpaying behavior, and code parallelization to support higher fidelity modeling. Note, even continuing with the EITC study has benefits as it would support some validation of the impact of local groups and tax assistance centers, and possibly relative timing of tax-related activity.

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Annual Report to Congress

National Taxpayer Advocate

2007 Annual Report to Congress

NORMATIVE AND COGNITIVE
ASPECTS OF TAX COMPLIANCE:
LITERATURE REVIEW AND
RECOMMENDATIONS FOR
THE IRS REGARDING
INDIVIDUAL TAXPAYERS

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2007

Annual Report to Congress

Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers

*Marjorie E. Kornhauser**

Summary

Why do people follow the law? The answer, under the traditional theory of compliance, is fear of detection and punishment. This deterrence theory, however, accounts for only a minor portion of actual compliance levels. It has such poor explanatory power because it assumes that the decision to comply is based solely on a cost-benefit analysis in which people rationally weigh the benefits of non-compliance against the costs of detection and penalties. Recent literature reveals, however, that the decision to comply is not purely rational. Rather, personal values, social norms, and non-rational cognitive processes also strongly affect the decision.

What holds true for law in general holds true for tax compliance specifically. Traditional methods of enforcement through audit and penalties explain only a small fraction of voluntary tax compliance. Theorists and researchers attribute the vast majority of compliance to what they loosely describe as internal motivations or “tax morale.” The field is still young, the subject complex, and some of the empirical data is inconclusive. Nevertheless, the literature clearly indicates that tax morale plays a major role in tax compliance.

Although the exact components of tax morale are not yet fully delineated, nor the precise mechanisms by which they work, the literature already has identified certain elements. Research shows that tax compliance is affected by (social and personal) norms such as those regarding procedural justice, trust, belief in the legitimacy of the government, reciprocity, altruism, and identification with the group. Cognitive processes, such as prospect theory, also influence an individual’s reaction to tax issues. Studies also indicate that certain demographic factors such as age, gender and education correlate with tax morale.

The components of tax morale, like internal motivators in other areas of the law, are not static. They interact with each other and the environment and are influenced by each individual’s own cognitive framework. Consequently, an external agent, such as the IRS, can influence tax morale norms and thereby tax compliance. It can activate compliance norms in a variety of ways including education, properly framing communications, fair procedures, and a regulatory framework that incorporates current and future findings of tax morale research into its operations and dealings with taxpayers.

* ©Marjorie E. Kornhauser, Professor of Law, Sandra Day O'Connor College of Law, Arizona State University. The author wishes to thank the Florida Tax Review for its assistance in providing Bluebook citations for this study.

Normative and Cognitive Aspects of Tax Compliance:
Literature Review and Recommendations for the IRS Regarding Individual Taxpayers

The Report makes three major recommendations. First, the IRS should establish a department devoted solely to exploring tax morale issues and implementing the findings. Second, the IRS should adopt a tax morale approach to tax compliance that recognizes the importance of taxpayers' internal motivations and the effects of societal conditions and institutions (such as the IRS) on these internal motivations. Third, using behavioral science research, the IRS should implement ongoing educational (long- and short term) programs and media campaigns. Since the subject of this Report is tax compliance of individual taxpayers, both the literature review and recommendations focus on individuals. However, like the tax morale concept itself, they are relevant for all taxpayers.

I. Introduction

If people hate taxes so much why do they pay them? The common, seemingly obvious, answer—fear of being caught cheating—is only a partial answer. In fact, this “obvious” answer—based on the rational cost/benefit analysis of traditional economic theory—explains so little of tax compliance that “[t]he puzzle of tax compliance is why people pay taxes instead of evading them.”¹ The key to this puzzle is “tax morale,” the collective name for all the non-rational factors and motivations—such as social norms, personal values and various cognitive processes—that strongly affect an individual's voluntary compliance with laws.² Higher tax morale correlates with higher tax compliance.

Although the exact components of tax morale are not yet fully delineated, Congress and the IRS should begin now to shape and administer income tax laws in accordance with tax morale findings. Delay can only increase the chance that voluntary compliance will deteriorate given the interaction of an individual's tax morale with elements of the external environment, such as other people and institutions. The tax gap, for example, is more than a problem of lost revenue; it is a visible sign of non-compliance that can create a downward spiral. Non-compliance among other taxpayers can decrease an individual's

¹ Lars P. Feld & Jean R. Tyran, *Tax Evasion and Voting: An Experimental Analysis*, 55 KYLKOS 197, 197 (2002). The traditional model of deterrence, based on detection and penalties, states that compliance with the law is a function of enforcement levels; a rational individual weighs the costs of non-compliance against the benefits. In the tax evasion context, this model states that a risk-averse taxpayer will engage in an amount of tax evasion that will maximize expected utility of income which is a function of “(i) the probability of detection, (ii) the penalty tax rate applied when tax evasion has been detected, (iii) the marginal tax rate, and (iv) the level of true income.” Werner W. Pommerehne & Hannelore Weck-Hannemann, *Tax Rates, Tax Administration and Income Tax Evasion in Switzerland*, 88 PUBLIC CHOICE 161, 162 (1996).

² “Voluntary” in this context, of course, means compliance without any actions taken by the tax collection agency. The literature is vast. Tax morale research is part of the more general field of inquiry into why people comply with laws generally. Two seminal books in the larger field are: ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991); TOM TYLER, *WHY PEOPLE OBEY THE LAW* (1990).

In the tax evasion context, the traditional deterrence model states that a risk-averse taxpayer will engage in an amount of tax evasion that will maximize expected utility of income which is a function of “(i) the probability of detection, (ii) the penalty tax rate applied when tax evasion has been detected, (iii) the marginal tax rate, and (iv) the level of true income.” Michael Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. Pub. Ec. 323 (1972); Kim M. Bloomquist, *Tax Evasion, Income Inequality and Opportunity Costs of Compliance*, NATIONAL TAX ASSOCIATION PROCEEDINGS, NINETY-SIXTH ANNUAL CONFERENCE 2003, 91 (2004).

The literature on tax morale alone is large. Some literature reviews include: James Andreoni, Brian Erard & Jonathan Feinstein, *Tax Compliance* 36 J. Econ. Lit. 818, 835 (1998) (only a few empirical studies on tax compliance before 1980); Benno Torgler, *Speaking to Theorists and Searching for Facts: Tax Morale and Tax Compliance in Experiments*. 16 J. Econ. Surveys 657 (2002). That the majority of knowledge in this area has occurred only in the past 5-7 years is evidenced by the rudimentary knowledge provided in the 1998 Andreoni *et. al.* review of the literature as compared to later articles.

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own tax morale and compliance.³ Once tax morale dips, it is hard to restore it to prior levels.⁴ Ironically, then, the more the tax gap is publicized, the greater this danger becomes. Consequently, Congress and the IRS should act now to narrow the tax gap and to foster compliance generally.

This Report offers the IRS several concrete suggestions for improving individual taxpayer compliance based on the tax morale literature. Part II discusses methodology and the limitations of empirical research. Part III briefly describes the tax morale literature, focusing on the main findings regarding: 1) cognitive and affective processes; 2) personal and social values/norms, especially procedural justice, legitimacy, reciprocity, and trust; 3) external activation and suppression of tax morale; 4) demographic factors; and 5) a new tax morale model for tax administration.

Part IV contains recommendations for the IRS. It presents three major recommendations and several more specific suggestions for the IRS to improve individual taxpayers' voluntary compliance. First, the IRS should establish a department devoted solely to exploring tax morale issues and implementing the findings. Second, the IRS should adopt a tax morale approach to tax compliance that incorporates the findings of the research and responds to—and strengthens—taxpayers' internal motivations to comply. Third, using tax morale research, the IRS should implement ongoing educational (long - and short term) programs and media campaigns. Although sticks as well as carrots are needed to ensure compliance, this Report examines only the carrots. Part V provides a short conclusion.

II. Methodology and Its Limitations

Methodology

This Report surveys recent literature concerning the “tax morale” model of tax compliance as it relates to individuals. It examines some of the cognitive processes involved such as framing, but it concentrates on the moral, psychological, and social factors influencing tax compliance.

The Report reviews a large quantity of tax morale literature but it is not comprehensive. It focuses on literature published in the last five years, which builds on and refines the first wave of literature. Within this time period, the Report reviews a substantial amount of the existing literature but not all since a comprehensive review would be both extremely lengthy and repetitive.

³ Bruno S Frey & Benno Torgler, *Tax Morale and Conditional Cooperation*, 35 J. COMP. ECON. 136 (2007).

⁴ See, e.g., Jon S. Davis, Gary Hecht & Jon D Perkins, *Social behaviors, enforcement, and tax compliance dynamics*, 78 ACCOUNTING REV. 39, 39 (2003); Ernst Fehr & Armin Falk, *Psychological foundations of incentives*. 46 EUROPEAN ECON. REV. 687 (2002); Jan Schnellenbach, *Tax morale and the taming of leviathan*, 17 CONST. POL. ECON. 117, 130 (2006); Michael Wenzel, *Misperceptions of social norms about tax compliance: From theory to intervention*, 26 J. ECON. PSYCHOL. 862 (2005).

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The Report examines empirical tax compliance literature in a variety of related fields such as behavioral economics and psychology, cognitive psychology, social psychology, and law, paying particular attention to tax morale (sometimes called taxpayer ethics).⁵ Some of the studies pertain to other countries, or are comparative in nature. In order to provide greater context, the Reviewer also briefly examined literature pertaining to norms, cognition, and the law generally.

For added perspective, the reviewed literature includes some materials in the fields of compliance with environmental laws and advertising/marketing. Compliance with environmental law has many similarities to tax compliance. Although some environmental laws do contain traditional “stick” deterrents such as fines, enforcement at the individual level largely depends on voluntary compliance, as in tax. Moreover, environmental and tax compliance share common collective action problems since the individual’s benefits from compliance are often attenuated and individual behavior is largely not visible to others. Marketing/advertising literature—with its long history of researching and applying knowledge of the psychological and social aspects of human behavior—is also relevant to tax compliance. Moreover, unlike the artificial environment of a controlled lab experiment, marketing occurs in the real world. Consequently, results in this field allow for the interplay of a variety of influences and may be observed over time.

The literature was obtained through searches on various databases such as: Lexis, Westlaw, Science Direct, EconLit and JSTOR, as well as various web pages such as those of the IRS and ATO. Additionally, the Reviewer interviewed several professionals in the UK—both in Treasury and Her Majesty’s Revenue and Customs (HMRC)—in order to obtain an overview of the UK perspective on compliance. These interviews occurred in May 2007.

Limitations of the Literature

Both theoretical and empirical research have limitations. Theories, of course, are limited by their point of view and their assumptions. Empirical research also has limitations. For example, how questions are phrased, and in what order, can affect responses. The gaps between belief, intention, and action can also result in unreliable responses. Self-reporting creates problems—there is a difference between what people report they believe and/or would do and what they actually believe or would do. This results from a variety of factors ranging from the fact that people often imperfectly perceive their own motivations, to the

⁵ Benno Torgler & Friedrich G. Schneider, *What Shapes Attitudes Toward Paying Taxes? Evidence from Multicultural European Countries* (May 2006). IZA Discussion Paper No. 2117 available at SSRN: <http://ssrn.com/abstract=901247>, at 3 (citing earlier studies).

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fact that people often report what they think the interviewer wants or what they think (or are told) the topic is.⁶

Sampling issues also influence empirical results. The population studied may not be representative. Different groups have different characteristics (*e.g.*, age, gender) which may obscure the causes of the results. Did the subjects, for example, respond in the way they did simply because of the apparent variable (*e.g.* presentation of numbers of taxpayers who evade) or were their reactions also influenced by the fact that the majority of the sample population was a particular age or gender? Results can also be skewed by what is called the “isolation” effect which causes people to focus on the information presented to them and ignore that which is not.⁷ As a consequence, people’s decisions frequently do not form a consistent whole. In the experimental context this means that a different outcome might occur if the survey question, or experiment, were presented in a different context with different salient facts.

One of the more important limitations of empirical research regarding compliance is the fact that much of the research has been conducted in a controlled laboratory situation. Although this allows researchers to isolate individual effects, it also weakens the results. In any controlled experiment, there is always the question of whether what the subject does in the controlled environment represents what he or she would do in the real world. This is amplified in the tax compliance area because it is often the confluence of a variety of factors that influence compliance.⁸ Moreover, many aspects of tax compliance develop over time so that even a laboratory study that offers repetitive chances may not capture the effects that develop over time. It is important to keep these limitations in mind when reading this literature review.

III. Literature Review

Tax morale refers to taxpayer attitudes and beliefs—not behaviors—but researchers are investigating the connection between the former and the latter. At its broadest, tax morale is an imprecise term—encompassing all the non-enforcement aspects of tax compliance.

⁶ Self-perception theory, in fact, is based on the assumption that people have imperfect knowledge of their motivations. See, *e.g.* Fehr & Falk, *supra* note 4, Fehr, at 714 (“A crucial assumption of self-perception theory is that individuals do not have perfect knowledge about the reasons for performing a task.”). Accord, Eric Kirchler, Apolonia Niemirowski & Alexander Wearing, *Shared subjective views, intent to cooperate and tax compliance. Similarities between Australian taxpayers and tax officers*, 27 J. ECON. PSYCHOL. 502-514 (2006) (imperfect self-perceived motivation); Torgler & Schneider, *supra* note 5, at 11 (people overstate their compliance); Viswanath Umashanker Trivedi, Mohamed Shehata & Stuart Mestelman, *Attitudes, Incentives, and Tax Compliance*, 53 CANADIAN TAX J. 29, 60 (2005) (lab experiments do not reflect real-life decisions, self-presentation problems ranging from poor memory of past behavior to desire to look good in eyes of experimenters).

⁷ Edward McCaffery & Jonathan Baron, *The Political Psychology of Redistribution*, 52 UCLA L. Rev. 1745, 1751, 1791 (2005).

⁸ See, *e.g.*, Robert B. Cialdini, *Social Motivations to Comply: Norms, Values, and Principles in 2* TAXPAYER COMPLIANCE 200, 201 (Jeffrey A. Roth & John T. Scholz eds., 1989).

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Current research is deconstructing this undifferentiated black box⁹ into its components. Some of these components are intrinsic factors—individual traits that motivate a person to comply such as a personal sense of integrity or degree of altruism. Others more directly relate to external conditions or societal norms such as procedural justice, trust in government, or the form of government.¹⁰ External and internal factors, however, interact and researchers are examining the ways in which internal motivations interact with external ones, each influencing and affecting the other and how cognitive processes can influence both.

This Part provides a short overview of three major areas in the rapidly growing field of tax morale research: cognitive and affective processes, social norms and personal values, and demographic factors. It then briefly describes a new model of a tax authority, frequently called a responsive or self-regulatory model, based on tax morale findings.

Cognitive and Affective Processes

Cognitive and affective processes are unconscious mechanisms that influence a person's perception and response to information, people, and the environment. Two cognitive processes are of particular importance to compliance. One is "framing." The manner in which acts, stimuli, or situations are presented—or framed—can affect a person's reaction to them. This effect is evident in surveys that result in different responses depending on what order questions are posed, for example, or whether the question is posed in the positive or negative. Labels also matter. For example, people generally react more favorably when a payment is called a fee rather than a tax.¹¹ Framing also affects various other tax attitudes such as preferences for progressive or flat rates, levels of taxes, and government spending.¹² One of the most important types of framing involves prospect theory, described below.

The other important cognitive process is what this Report labels "shortcuts." Shortcuts encompass a variety of overlapping, somewhat amorphous, concepts variously called heuristics,¹³ cultural cognitions,¹⁴ or schemas. Collectively, they are the mechanisms that

⁹ Richard M. Bird, Jorge Martinez-Vasquez & Benno Torgler, *Tax Performance in Developing Countries: The Role of Demand Factors*, NATIONAL TAX ASSOCIATION, PROCEEDINGS NINETY-SEVENTH ANNUAL CONFERENCE 2004, 284, 287 (2005). (tax morale is the "intrinsic motivation to pay taxes"); Lars P. Feld, & Bruno S. Frey, *Trust Breeds Trust: How Taxpayers Are Treated*, 3 ECON. OF GOVERNANCE 87, 88-9 (2002); Torgler & Schneider, *supra* note 5, at 3. (tax morale as the "moral obligation to pay taxes, a belief in contributing to society by paying taxes.") Schnellenbach defines tax morale 'pragmatically' 'as the phenomenon that taxpayers (1) on average evade less taxes than an optimization calculus incorporating only expected judicial punishment and reasonable levels of risk aversion would predict and (ii) systematically adjust their evasion levels according to how satisfied they are with public policy, processes of collective decision-making and the quality of their relationship to authorities.' Schnellenbach, *supra* note 4, at 118.

¹⁰ See, e.g., James Alm & Benno Torgler, *Culture difference and tax morale in the United States and in Europe*, 27 J. ECON. PSYCHOL. 224 (2006) (arguing that "tax morale is likely to be influenced by such factors as perceptions of fairness, trust in the institutions of government, the nature of the fiscal exchange between taxpayers and government, and a range of individual characteristics."

¹¹ McCaffery & Baron, *supra* note 7, at 1760. This is not true, however, in regards to existing services that are funded by a general tax. In that situation, respondents do not prefer a fee because they perceive it as paying for a service/good that they are already getting for "free." *Id.*

¹² *Id.*

¹³ See, e.g. John T. Scholz & Neil Pinney. *Duty, Fear, and Tax Compliance: The Heuristic Basis of Citizenship Behavior*, 39 AM. J. POL. SCI. 490, 491 (1995). (heuristic as cognitive short cut).

¹⁴ Dan Kahan & Donald Braman, *Cultural Cognition and Public Policy*. 24 Yale L. & Policy, 149 (2005).

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allow people to respond quickly to the otherwise overwhelming amount of stimuli that bombard them daily. They create general “rules of thumb” that allow individuals to efficiently acquire, store, organize and retrieve knowledge; they influence a person’s perception of new data and one’s reactions to it. Shortcuts involve both cognitive and affective processes and are the product of various factors such as cognitive processes (such as framing), psychological traits, prior experiences, social and personal norms.

Different worldviews or cultural cognition shortcuts incorporate different norms and values. A person with an individualist worldview, for example, strongly incorporates the norms of self-reliance, independence, and effort whereas the values of a person holding the opposite collectivist view would emphasize equality, reciprocity, cooperation, and so forth. Some worldviews (cultural cognitions or schemas) are associated with particular demographic groups—racial, religious, regional, gender, or age-based for example.

Shortcuts generally do not change in the face of new information because they are based on values not information.¹⁵ As a consequence, Kahan and Braman argue that successful policies must be framed so as to appeal to people with different views. Tradable emission permits are an example of such a policy.¹⁶ Individualists like the permit policy, they claim, because its market mechanism appeals to their belief in private enterprise; “hierarchists” support it because it leaves power in the hands of powerful commercial entities, and egalitarians and collectivists support it because it recognizes their goal of improving air pollution and the need to constrain industry.¹⁷

Framing: Prospect Theory

Prospect theory is probably the framing effect most relevant to tax compliance.¹⁸ The theory, which explains how people evaluate risk, holds that people are risk averse in regards to gains but risk-seeking in regards to loss. Consequently, the manner in which a decision is framed will affect a person’s willingness to take risks. In income tax, for example, whether an issue is framed as a bonus for those with children (such as a child credit) or a penalty for the childless will affect a taxpayer’s attitude toward the provision.¹⁹ It also means that a taxpayer will be more willing to take risks (not comply) when the issue is framed as a loss (penalty from an audit) than as a gain (a bonus from a refund).²⁰ Consequently, the manner in which information is communicated to a taxpayer can have a major impact on his willingness to comply with the tax laws.

¹⁵ Dan Kahan & Donald Braman, *Cultural Cognition and Public Policy*, 24 *Yale L. & Policy*, 152-3 (2005).

¹⁶ *Id.*

¹⁷ *Id.* at 169. Also French abortion reform that ‘conditioned abortion on an unreviewable certification of personal “distress.” That policy made it possible for both religious traditionalists, who interpreted certification as symbolizing the sanctity of life, and egalitarians and individualists, who interpreted unreviewability as affirming the autonomy of women, to see their commitments affirmed by the law.” *Id.* at 168.

¹⁸ John Cullis, Philip Jones & Alan Lewis, *Tax Framing, Instrumentality and individual differences: Are there two different cultures?* 27 *J. Econ. Psychol.* 304, 306 (2006). See, generally, *CHOICES, VALUES, AND FRAMES* (Daniel Kahneman & Amos Tversky eds., 2000).

¹⁹ McCaffery & Baron, *supra* note 7, at 1758.

²⁰ Cullis *et al*, *supra* note 18, at 306.

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According to prospect theory, tax compliance should increase if paying taxes is seen as a gain not a loss. If a taxpayer views his situation as interconnected with the nation's either because he or she is a collectivist (see worldview below) and/or through identification with the nation, then taxpaying is more likely to be viewed as a gain than a loss.²¹ One study suggests that if a taxpayer views taxes as a national obligation, then after tax income is the taxpayer's reference point and therefore:

tax compliance decisions are made in the gain domain, which leads taxpayers to pursue risk-averse behavior. On the other hand, if the taxpayer considers paying taxes as loss, then his/her reference point would be their income before tax. In this case, the taxpayer will be likely to engage in risk-seeking behavior.²²

Short Cuts/Worldviews

Several worldviews with deep roots in America are especially relevant to tax compliance. Two interrelated ones involve the twin political foundations of American democracy: equality and liberty. The first worldview concerns the relationship of the individual to the group (individualistic versus collective orientation; the second view concerns the nature of society (hierarchical versus egalitarian).²³ Individualistic, hierarchical people emphasize negative liberty more than equality and therefore look to the individual, not the government, to solve social problems. Such a taxpayer will be less likely than a collectivist/egalitarian taxpayer—who emphasizes equality and positive liberty—to support higher or redistributive taxes. A collectivist-oriented and/or egalitarian individual, in contrast, will be more willing to pay taxes even if her tax burdens exceed her individual benefits (*i.e.*, no material fiscal exchange equity) if the taxes help the group. Moreover, this person might consider the reduction of inequality and the provision of goods to others a benefit when determining whether there is fiscal equity.²⁴ He or she will see paying taxes as a gain, fulfilling personal desires and civic obligations and not just a loss of personal income. As a result, according to prospect theory, she will be risk-averse and more willing to comply.

Two other “schemas” or “worldviews” with deep historical roots in American history and politics can negatively influence tax compliance—a general anti-tax schema and an anti-establishment schema. As to the first, although tax compliance—and tax morale—is relatively high in the United States compared to other countries, many Americans harbor

²¹ See, PHILLIP HANSEN, TAXING ILLUSIONS, TAXATION, DEMOCRACY AND EMBEDDED POLITICAL THEORY 16 (2003)(for citizens “the issue of what politics means and what kind of democracy is desirable turns on a fundamental question...: To what extent can my purposes be fulfilled only together with others; indeed to what extent are my purposes *our* purposes... With respect to taxation, this raises the question of whether taxes are charges imposed on us by remote political authorities we are always reluctant to pay and do so only because we are coerced, or whether they are self-imposed levies, expressions of our commitment to the wellbeing of all.”).

²² Viswanath Umashanker Trivedi, Mohamed Shehata, & Bernadette, Lynn, *Impact of Personal and Situational Factors on Taxpayer compliance: An Experimental Analysis* 47 J Bus Ethics 175, 179 (2003).

²³ See, e.g., Kahan & Braman, *supra* note 14, at 153 (Winter 2006)(citing Mary Douglas and political scientist Aaron Wildavsky, *Risk and Culture* (1982)); Daniel W.; Barrett, Wilhelmina Wosinska, Jonathan Butner, Petia Petrova, Malgorzata Gornik-Durose & Robert B. Cialdini, *Individual differences in the motivation to comply across cultures: the impact of social obligation*, 37 PERSONALITY AND INDIVIDUAL DIFFERENCES 19 (2004).

²⁴ See, e.g., Barrett, *et. al.*, *supra* note 23. Accord, Michael Wenzel, *An Analysis of norm processes in tax compliance*, J. ECON. PSYCHOL. 213, 221 (2004) (social norms that are internalized as personal norms positively affect compliance, but otherwise have a negative effect).

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strong anti-tax sentiments which are part of a national anti-tax schema that reaches back to the founding of the nation and forward to the present. Protesting a tax by dumping tea in the Boston Harbor was patriotic in the 18th century and this symbolic gesture resonated in the 20th century when the Internal Revenue Code was dumped into the harbor. Many tie freedom from tax to liberty and to be anti-tax is seen as patriotic.²⁵ There is some evidence that an anti-establishment schema, perhaps more prevalent with those who have an anti-tax and/or individualistic view, is significantly related to tax compliance.²⁶ Like the anti-tax schema the anti-establishment schema—a Jeffersonian belief that small government is the best government—has deep roots in the American psyche. Logically, a person operating under this schema might support a small tax that pays for the small amount of necessary government. However, in practice, antipathy to government and antipathy to tax frequently accompany each other, especially if the tax and the government are larger than one prefers.

Worldviews not only affect attitudes towards a substantive policy, but also affect responses to methods of enforcing the policy. A policy may be consistent with a person's worldview, but the method of enforcement may not. Shaming is an example of such a policy. Recently, shaming has gained a lot of attention in several legal areas such as criminal law as an alternative to more traditional enforcement techniques such as imprisonment. It is also being used in the tax area. Several states, such as Alabama, California, North Carolina, and Wisconsin have used shaming devices by publicizing the names of delinquent taxpayers. Even the Internal Revenue Code has a limited amount of shaming: § 6039G (d) publicizes in the Federal Register the names of taxpayers who expatriate for tax reasons.

In some situations shaming sanctions may not only be ineffective but they may also backfire. They are ineffective on individuals who are not ashamed of their behavior and/or are not concerned for other reasons, such as reputation, that others know they have violated a compliance norm. Shaming may also be ineffective for a person who has internalized the norm but has an individualistic worldview. Such a person will be hostile to shaming, which is based on a collectivist, communal worldview, and that hostility may even undermine support for the underlying policy.²⁷

People with different worldviews/cultural cognitions may have some social norms and personal norms that are the same, but others that differ. A taxpayer with an individualistic

²⁵ See, e.g., President Reagan, for example, on the signing of the Tax Reform Act of 1986, called the prior code “un-American” stating that “Throughout history, the oppressive hand of government has fallen most heavily on the economic life of the individuals. And, more often than not, it is inflation and taxes that have undermined livelihoods and constrained their freedoms.” *President Reagan's Remarks During Tax Bill Signing Ceremony* (Oct. 22, 1986) reprinted in 33 TAX NOTES 413 (1986). See also, *Excerpts from the President's 1988 Legislative and Administrative Message to Congress*, 38 TAX NOTES 499 (Feb. 1, 1988) (“If individuals are to possess genuine autonomy, then they must be free to control their own resources, to enjoy the fruits of their labor, and to keep what they earn, free from excessive government taxation and spending”). More generally, see, Marjorie E. Kornhauser, *Legitimacy and the Right of Revolution: the Role of Tax Protests and Anti-Tax Rhetoric in America*, 50 Buff. L. Rev. 819 (2002).

²⁶ Trivedi, Shehata, & Lynn, *supra* note 22, at 187 (‘A score’, level of anti-establishment is statistically significantly related to tax compliance).

²⁷ Dan M. Kahan has recanted his support of shaming in the criminal law area because of its divisive nature. Dan M. Kahan, *What's Really Wrong with Shaming Sanctions?* (2006) SSRN 914503. (Sanctions, like the policies they enforce, must be devised in as ambiguous a way as possible so as to appeal to people with diverse worldviews; shaming is too divisive).

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worldview, for example, is less likely to have egalitarian values than a collectivist. Both, however, may follow the same norm of procedural fairness. The next section examines some of the social norms and personal values that affect tax morale generally.

Social Norms and Personal Values

Both social and personal norms affect tax morale. Social norms—shared beliefs concerning the manner in which people should behave—are enforced by informal social sanctions.²⁸ They are external to individuals whereas personal (moral, ethical) norms or values are internal. When a person internalizes a social norm, it becomes a personal one. Internalized personal norms are more likely to affect behavior in large groups, especially in situations where an individual's actions are not readily observable by others. Social norms are less influential in this type of situation because of the problems of free-riding and the difficulty of imposing sanctions.²⁹

Some internal norms have strong positive impacts on tax compliance. Values indicating high moral reasoning—honesty and altruism, for example—provide internal rewards that can positively affect tax compliance.³⁰ A person may act on this personal norm regardless of what others are doing. However, norms are not static; they interact with each other and with the environment.³¹ For example, a taxpayer may initially follow her own personal norm of integrity and file accurate tax returns regardless of the social norm which tolerates cheating. However, the taxpayer's perception that others are cheating can influence her personal norms, lower tax morale and change compliance behavior. External norms of conformity or reciprocity, for example, can alter her norm of integrity to justify some cheating as can the desire not to be seen as a “chump” who follows the law when everyone else doesn't.

Identification with the group plays a crucial role in norm formation and influence. The more a person identifies with a group, the more likely he or she is to internalize its norms and therefore cooperate, that is, follow them.³² Some studies suggest that if a taxpayer does

²⁸ See, e.g., Ivar Kolstad, *The evolution of social norms: with managerial implications*, J. SOCIO-ECONOMICS, 36, 59 (2007). Accord, Ernst Fehr & Urs Fischbacher, *Social norms and human cooperation*, 8 TRENDS IN COGNITIVE SCIENCES 185, 185 (2004) (“Social norms are standards of behaviour that are based on widely shared beliefs how individual group members ought to behave in a given situation.”).

²⁹ Studies show, for example, that people are more likely to recycle—an action that may not be easily observable or have much effect if others do not similarly recycle—if they believe it is good for the environment or a civic duty. See, e.g., Thomas C. Kinnaman, *Explaining the Growth in Municipal Recycling Programs: The Role of Market and Nonmarket Factors*, 152 in THE ECONOMICS OF HOUSEHOLD GARBAGE AND RECYCLING BEHAVIOR (Don Fullerton & Thomas C. Kinnaman eds., 2002) (respondents were more likely to participate in recycling if they believe that recycling was good for the environment than if they thought it was their civic duty); Ann E., Carlson, *Recycling Norms*, 89 CA. L. REV. 1231 (2001) (Commitment to recycling influences recycling behavior but mostly in small groups requiring little effort); Georgina Davis, Paul S. Phillips, Adam D. Read & Yui Iida, *Demonstrating the need for the development of internal research capacity: Understanding recycling participation using the Theory of Planned Behaviour in West Oxfordshire, UK.*, 46 RESOURCES, CONSERVATION AND RECYCLING 115 (2006) (intention to recycle influenced by belief that it was good for the environment).

³⁰ See, Nina Mazar & Dan Ariely, *Dishonesty in Everyday Life and Its Policy Implications*, 25 AM. MARKETING ASS'N 117, 124 (2006); Trivedi, Shehata, & Lynn, *supra* note 22, at 187 (an increase in the P Score—a measure of the level of moral reasoning—increased compliance while a decrease in the P score decreased compliance).

³¹ Wenzel, *supra* note 24.

³² Tom R. Tyler, *Why People Obey the Law* (1990); Tom R. Tyler & Steven L. Blader, *The Group Engagement Model: Procedural Justice, Social Identity, and Cooperative Behavior*, 7 PERSONALITY AND SOCIAL PSYCHOL. REV. 349, 355 (2003). Torgler makes the same point in many articles.

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not identify with the group holding the social norm, then the norm can actually negatively affect compliance.³³ However, even if a person does not identify with a group norm, he or she may comply with its norms for rational based reasons such as reputation. Compliance with laws “signals” that the person is trustworthy, honest or reliable.³⁴ For example, politicians engage in signaling when they open their tax returns to public scrutiny. Normally, however, signaling does not occur in the income tax context because tax returns are generally confidential.³⁵ Signaling would occur, however, if there were some publicity of tax information, such as publicizing the names of delinquent taxpayers.³⁶

Identification with a group encourages individuals to be collectively oriented, and therefore, more likely to forgo immediate self interest for the sake of the public good. A taxpayer who is strongly identified with the group is more likely to see a tax not simply as coercion, but as “self-imposed levies, expressions of our commitment to the well-being of all.”³⁷ In other words, identification with the group either decreases the importance of fiscal exchange—an element of procedural justice, as discussed below—or is more broadly defined to include others.

Identification with a group smaller than the nation also can positively influence internal motivations to comply with tax laws. If business leaders, for example, emphasize the importance of paying taxes (personally and at the corporate level), then other business-oriented people will see that as the norm. Similarly, having an important person in a group (a minister, for example) or a person that people admire or respect (*e.g.*, celebrity) emphasize tax compliance could strengthen compliance.

Strengthening the identification of tax professionals with the integrity of the tax system can improve their willingness to cooperate with the IRS. This would decrease aggressive tax planning directly since much of such advice is “supply” driven by the professionals.³⁸ It would also signal to clients a tax compliance norm that could have a ripple affect on their clients, who respect and identify with these professionals.

A major reason people join groups and cooperate is because they obtain a sense of identity (self-worth, esteem) from the group.³⁹ Consequently, the more one identifies with the group

³³ See, *e.g.*, Wenzel, *supra* note 24.

³⁴ Alex Raskolnikov, Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-adjusting Penalty, 106 COLUMBIA LAW REVIEW 569 (2006).

³⁵ Dan M. Kahan, Signaling or Reciprocating? A Response to Eric Posner’s Law and Social Norms. 36 U. RICHMOND L. R. 375 (2003) *But see*, Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000).

³⁶ *But see*, Raskolnikov, *supra* note 34 (tax compliance as reputational signaling device) and Kahan *Posner Response*, *supra* note 35 (reciprocity is better explanation of compliance). My conversation with Karl Knapp of the N.C. department of revenue says there was anecdotal evidence that threat of publication increased compliance rather than the shame of actually being listed. E-mail from Karl Knapp to author March 2, 2007. This is some evidence that shaming could perform a signaling function.

³⁷ HANSEN, *supra* note 21, at 16.

³⁸ JOHN BRAITHWAITE, *MARKETS IN VICE: MARKETS IN VIRTUE* 50-66 (2005); Dennis J. Ventry, Jr., *From Competition to Cooperation: Imagining a New Tax Compliance Norm* (2007 forthcoming).

³⁹ Tyler & Blader, *supra* note 32.

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the more one internalizes norms and cooperates. Identification with the group is therefore crucial to cooperation and procedural fairness is crucial to forming that identification.⁴⁰

Procedural fairness, or justice, is a major determinant of tax morale generally, not just in the fostering of identification. Key components of procedural justice are: voice⁴¹ (participation in the process and belief authorities “hear” the individual), belief in the neutrality of the decision; belief in the neutrality of the decision-maker; and being treated with respect, politeness and dignity by tax authorities.⁴² A belief in the legitimacy of the authority and trust in it, which a sense of procedural fairness augments, also increase identification with the group and compliance with its norms.

Although a belief in the legitimacy of the tax system is ultimately tied to the greater issue of legitimacy of the government which the taxes support, individuals’ direct contacts with the tax authority greatly influence their perception of whether an authority is legitimate and procedurally fair.⁴³ The more an individual believes he or she is heard and treated fairly, the more he or she believes the authority is responsive and therefore procedurally just.⁴⁴ The lack of responsiveness, according to some scholars, is a major cause of the ultimate act of non-compliance in the tax area—revolt.⁴⁵

Procedural justice builds trust, loyalty, identification, and commitment that can survive the occasional negative interaction with the authority. Commercial companies, for example, devise complaint procedures which preserve customer loyalty even in the face of negative experiences.⁴⁶ Procedural justice can work similarly in the tax context. By strengthening normative bonds, it can help maintain compliance even in the face of significant negatives

⁴⁰ *E.g. Id.* at 355.

⁴¹ See, e.g., Alm & Torgler, *supra* note 10; Feld & Frey, *supra* note 9; Benno Torgler, Tax Morale and Direct Democracy, 21 EUR. J. POL. ECON. 531 (2005).

⁴² Numerous articles make these points. See, e.g., Tom Tyler, *supra* note 2); Lars P. Feld & Bruno S. Frey, *Tax Compliance as the Result of a Psychological Tax Contract: The Role of Incentives and Responsive Regulation*, 29 L. & Pol’y 102 (2007); Torgler, *supra* note 2; Tyler & Blader, *supra* note 32; Tom R. Tyler & David De Cremer, *Process-based Leadership: Fair Procedures and Reactions to Organizational Change*, 16 LEADERSHIP Q. 529 (2005); Tom R. Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings*, 70 BROOKLYN L. REV. 1287 (2005).

⁴³ See, e.g., Natalie Taylor, *Explaining Taxpayer Non-Compliance through Reference to taxpayer Identities: A Social Identity Perspective* 39, 51 in SIZE, CAUSES AND CONSEQUENCES OF THE UNDERGROUND ECONOMY: AN INTERNATIONAL PERSPECTIVE (Christopher Bajada & Friedrich Schneider eds. 2005); Raskolnikov, *supra* note 34.

⁴⁴ See, e.g., Kent W. Smith, *Reciprocity and Fairness: Positive Incentives for Tax Compliance* 223, 228 in WHY PEOPLE PAY TAXES (Joel Slemrod, ed., 1992) (although procedural justice and responsiveness are different, “the two components may be cumulative in such regulatory areas as tax administration, in the sense that responsive service may be viewed by many as a precondition for procedural fairness in decision making and the administration of the laws.” Therefore, it is “reasonable to expect that perceptions of pf are an intervening variable between perceptions of responsive service and normative commitment.”). Kent also highlights the (probable) importance of reciprocity and the legitimacy.

⁴⁵ See, e.g., Jack Citrin, *Introduction at 19 in CALIFORNIA AND THE AMERICAN TAX REVOLT: PROPOSITION 13 FIVE YEARS LATER* (Terry Schwadron, Ed; Paul Richter, Principal writer 1984), (“a failure on the part of elected officials to meet burgeoning complaints about high taxes at least partway was critical to the success of the tax revolt. The rebels won their greatest victories, in California and Massachusetts, where the political system was unresponsive to an obvious problem—in other words, where democratic processes broke down.”). Lack of responsiveness by officials also played an important role in other tax revolts in the United States such as Shays’ Rebellion and the Whiskey Rebellion. Kornhauser, *supra* note 25.

⁴⁶ Consumer research indicates that in order to build a long-lasting connection between a customer and a brand, the customer must be “committed” to the brand. This relationship exceeds the usual “brand loyalty” marketers discuss; loyalty is functional, arising from satisfaction with the brand whereas commitment is personal and based in the consumer’s trust in the brand. A committed customer is “slightly more forgiving of the brands’ foibles since the relationship has escaped the limitations of a straightforwardly utilitarian nature.” Jeff Hess & John Story, *Trust-based Commitment: Multidimensional Consumer-brand Relationships*, 22 J. CONSUMER MARKETING 312, 321 (2005). See, also, Hooman Estalami, *Competitive and Procedural Determinants of Delight and Disappointment in Consumer Complaint Outcomes*, 2 J. SERVICE RESEARCH 285, 289 (2000) (promptness, politeness, empathy improve commitment).

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such as fiscal exchange inequities, IRS mistakes, or taxpayer complaints. Theoretically, then, certain existing structural aspects of the tax process, such as the taxpayer bill of rights and the National Taxpayer Advocate, should have a positive effect on compliance. The more the IRS strengthens its own norms of honesty, fairness, and politeness in its communications and interactions with taxpayers, the more taxpayers will view the IRS and its decisions as fair.⁴⁷ This increased perception of procedural justice should improve tax morale and tax compliance.

The norm of reciprocity, like procedural justice, improves tax morale. Acting under this norm, an individual will respond to another's act in the same way in which that person treated him.⁴⁸ If another person is generous or honest, for example, the individual feels obligated to respond in kind and is more likely to do so. However, if the other person acts negatively—such as cheats or shirks—the individual will respond in a similarly negative fashion. Acting under a norm of reciprocity, a person may voluntarily comply with tax laws even if he or she does not personally experience fiscal equity in the tax/government benefit exchange because he or she is helping the collective good. Strong norms of reciprocity, therefore, increase cooperative behavior. Reciprocity and cooperation increase when people trust that others will indeed reciprocate.

Several studies indicate that trust and reciprocity hold true in the tax area as well as generally. An individual taxpayer's compliance after the Tax Reform Act of 1986 correlated, according to one study, with exposure to other taxpayers' positive attitudes to the act, rather than the amount of personal benefit from the reforms (*i.e.* decreased taxes).⁴⁹ Positive attitudes indicated greater willingness to comply, which in turn "trigger[ed] the disposition to reciprocate in kind. In effect, the enactment of popular reforms generates an environment of face-to-face assurance giving that builds trust, and a resulting disposition to cooperate, in much the same way that discussion does in public goods experiments."⁵⁰ Learning that most people pay their taxes can similarly reinforce trust and reciprocity.⁵¹

Reciprocity theory implies that a very effective method of promoting cooperative behavior is "to promote trust—the shared belief that others can in fact be counted on to contribute their fair share to public goods, whether or not doing so is in their material self-interest."⁵² The best ways to promote trust is to promote procedural justice, legitimacy, and identification.

⁴⁷ Organizations also have norms and like individual norms can be changed. Kolstad, *supra* note 28; Tyler & De Cremer, *supra* note 38 (leaders can motivate others in the organization to accept change through fair procedures).

⁴⁸ See, e.g., Dan M. Kahan, *Logic of Reciprocity* 102 MICH. L. REV. 71 (2003), Kahan *Posner Response*, *supra* note 35; Dan M. Kahan, *Trust, Collective Action, and Law*, 81 B.U.L. REV. 333, 333 (2001).

⁴⁹ Kahan Trust, *supra* note 48, at 341, citing Marco R. Steenberg et al., *Taxpayer Adaptation to the 1986 Tax Reform Act: Do New Tax Laws Affect the Way Taxpayers Think About Taxes?*, in *Why People Pay Taxes* 9 (Joel Slemrod, ed., 1992).

⁵⁰ Kahan Trust, *supra* note 48, at 343.

⁵¹ See, Kahan, *supra* note 35.

⁵² *Id.* at 369.

Impact of External Factors on Internal Motivations

Although tax morale is internally motivated, the outside world affects it. External factors—such as contextual clues, rewards, education, and the framing of communications—can either weaken (“crowd out”) internal motivators or strengthen (crowd in) internal motivations. IRS actions may have either effect, often unintentionally. By understanding the workings of tax morale, the IRS can maximize positive effects and minimize those that crowd out tax morale.

The commoditization of a behavior crowds out positive normative influences on that behavior. Thus, setting a price or giving an economic incentive for behavior motivated by social, non-pecuniary motives such as reciprocity can actually decrease the desired behavior. In the environmental field, for example, subsidies, some argue, crowd out normative behaviors.⁵³ In tax, it is possible that commodification occurs when taxpayers are called “customers.” The effects of crowding out can be permanent so that decreased compliance remains even after the discontinuance of the economic incentive or other commoditizing event.⁵⁴

The manner in which a communication is framed can either activate or suppress internally motivated normative behavior. In one experiment, subjects received \$18. Half the group was told that \$2 had been given to a charity of their choice; the other half was told that they had been given \$20 but the government had taken \$2 in taxes which was then given to the charity of their choice. When asked if they wanted to make additional charitable contributions, those that had been “taxed” did not, but those subjects who had simply been told \$2 had gone to charity contributed more.⁵⁵ Although neither group had a choice whether to give the initial \$2, the “tax” situation highlighted the compulsory aspect (or alternatively framed the situation as a loss situation since \$2 of their money had been taken from them). This crowded out the voluntary charitable behavior.

Phrasing norms positively generally encourages or activates normative behavior (at least for women). For example, stating that most people comply with tax laws reminds people what the norm is and encourages them to follow it. This crowding in effect may be due to the effect of conformity and reciprocity norms. On the other hand, framing communications negatively, by emphasizing the number of people who violate the norm, crowds out normative behavior. For example, theft of petrified wood at the Petrified Forest National Park decreased when a sign—with a line through it—showed only one person stealing wood as opposed to three.⁵⁶ When college students are told that the average student

⁵³ Andrew Green, *You Can't Pay Them Enough Subsidies: Environmental Law and Social Norms*, 30 HARV. ENVTL. L. REV. 407 (2006)(subsidies put a price on environmental behavior and crowd out behavior based on responsibility). *But see*, Carlson, *supra* note 29 (market mechanisms do decrease “bad” recycling behavior and increase “good” behavior).

⁵⁴ Fehr & Falk, *supra* note 4.

⁵⁵ Catherine C. Eckel, Philip J. Grossman & Rachel M. Johnston, *An Experimental Test of the Crowding Out Hypothesis*, 89 J. Pub. Econ. 1543 (2005).

⁵⁶ Robert B. Cialdini, *Descriptive Social Norms as Underappreciated Sources of Social Control*, 107 PSYCHOMETRIKA 263, 266 (2007)(theft actually increased when the sign showed 3 thieves).

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consumes four drinks on a Saturday night, those who consume more decrease their drinking, but those who drink less than four increase their consumption.⁵⁷ Similarly, communications stating how many people are evading taxes might decrease compliance among formerly compliant taxpayers because their perception about the strength of the norm and how many taxpayers follow it (reciprocity) diminishes.

Laws can influence behavior and activate personal norms in various ways. “Expressive” provisions, such as shaming, signal socially approved behavior, as well as increase the costs (penalties) of disapproved behavior. They, therefore, have the potential to shape social norms and increase compliance.⁵⁸ They work best, however, if individuals identify with the group and have a similar worldview, as discussed previously. Consequently, shaming, a technique with which several states are experimenting by publicizing tax delinquents, may not only be ineffective for those who do not identify with the norm (paying taxes), but may backfire and indicate to those who are compliant that the norm is not followed by many people.⁵⁹

Crowding-in can occur through internal rewards. For example, being treated respectfully—an aspect of procedural fairness—can activate internal motivations.⁶⁰ Moreover, seeing examples of the desired behavior can activate a person’s norms. For example, when people hear, see, or read about polite behavior, they will act more politely,⁶¹ or they will donate more to a box in the museum if the box already has money in it.⁶² These external cues activate the norm of reciprocity or perhaps the norm of conformity in which people act as others do even though there is no chance of receiving a reciprocal benefit.⁶³

Several opportunities to provide external cues to activate tax compliance norms occur at the time returns are filed. For example, Mazar and Ariely suggest that the IRS could ask taxpayers to sign an “honor code” just before they fill out their returns.⁶⁴ Cialdini suggested that taxpayers be given the opportunity on their tax form to contribute a nominal sum to fighting tax evasion.⁶⁵ Such a fund is framed negatively and therefore might backfire and decrease compliance, but the idea, framed more positively, is intriguing. For example, the contribution could be to fund IRS tax advice to the public or a segment of the public (such as the poor) or to fund special tax education programs. Another possibility, borrowed from

⁵⁷ Robert B. Cialdini, speech at Sandra Day O’Connor ASU College of Law (January 29, 2007).

⁵⁸ See, Michael S. Kirsch, *Alternative Sanctions and the Federal Tax Law: Symbols, Shaming, and Social Norm Management as a Substitute for Effective Tax Policy*, 89 IOWA L. REV. 863 (2004). Politics itself can be seen as symbolic. For the classic exposition of this theory see, MURRAY EDELMAN, *THE SYMBOLIC USES OF POLITICS* (1964).

⁵⁹ See notes 27 and 58 and accompanying text, *supra*, regarding ineffectiveness of shaming.

⁶⁰ See, e.g., Feld & Frey, *supra* note 48 at 106.

⁶¹ E.g., MALCOLM GLADWELL, *BLINK: THE POWER OF THINKING WITHOUT THINKING* 25 (2005).

⁶² Frey & Torgler, *supra* note 3.

⁶³ Nicholas Bardsley & Rupert Sausgruber, *Conformity and Reciprocity in Public Good Provision*, 26 J. ECON. PSYCHOL. 664 (2005).

⁶⁴ See Mazar & Ariely, *supra* note 26.

⁶⁵ Cialdini, *supra* note 8. The federal government currently allows taxpayers to contribute to the Federal election campaigns and some states allow taxpayers to contribute to various funds.

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campaigns to get out the vote at election time, is to provide taxpayers with stickers that say “I paid my taxes today.” This visible sign of compliance might activate norms of reciprocity and trust that would encourage others to similarly pay their taxes.

Education can strengthen norms. Since norms and morality are acquired through a process of socialization, education can strengthen norms that are positively correlated with tax compliance such as honesty, morality, national pride, concern for others, and fairness.⁶⁶ Policy makers and administrators can develop programs that not only provide tax information but also “reinforce the concept of fairness of the tax system among taxpayers; and develop programs that enhance and appeal to a taxpayer’s moral conscience and reinforce social cohesion.”⁶⁷

Although it is clear that external factors can activate or suppress tax morale, laboratory studies and field experiments with actual taxpayers produce mixed results regarding normative appeals to pay taxes.⁶⁸ Some studies show no impact or even a negative one. These results, however, do not necessarily mean that external factors cannot activate norms. Peculiarities of the studies themselves may be the cause. For example, the normative appeal may fail because there was too long a time lag between the communication and the compliance decision, or because the communication was a “one-shot” deal or was not framed properly.⁶⁹ Moreover, as discussed below, normative appeals appear to work better with some segments of the population.

Demographic Factors

Various demographic factors correlate with tax compliance behavior, such as age, gender, and religiosity. These are correlations not causations and may reflect different worldviews, schemas, framing, or a combination of these. Although the precise reasons for the correlations are not known, knowledge that they exist is useful in devising compliance tactics. What helps one population may be a detriment to another. Studies have found these major demographic correlations:

⁶⁶ See, e.g., Mazar & Arieli, *supra* note 30 at 123 (“likely possibility” that critical period for developing these norms is in youth); Trivedi, Shehata & Lynn *supra* note 22, at 193. (“Policymakers, ... should develop programs that help enhance these characteristics in the general population to raise the level of tax compliance. Encouraging education can be one such measure, given the finding in prior research ... that education and age are the most important determinants of moral reasoning. Thus, education with an emphasis on ethics, and the ethics of taxation specifically, may improve tax compliance. Further, the results also highlight the importance of encouraging and maintaining a positive attitude towards governments among the general population to achieve a tax compliant population. Thus, policies that encourage/emphasize education and ethical behavior may be an effective method of increasing the level of taxpayers’ compliance.”)

⁶⁷ See, e.g., Mazar & Arieli, *supra* note 30 at 123 (“likely possibility” that critical period for developing these norms is in youth); Trivedi, Shehata & Lynn *supra* note 22, at 193.

⁶⁸ E.g., studies of effect of letters sent to Minnesota taxpayers. Marsha Blumenthal, Charles Christian, & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, (2001) 54 Nat’l Tax J. 125; Jon Hasseldine, Peggy A. Hite, Simons James & Marika Toumi, *Carrots, Sticks, Sole Proprietors, and Tax Accountants, Recent Research in Tax Administration and Compliance*, PROCEEDINGS OF THE 2005 IRS RESEARCH CONFERENCE 213 (2006); Joel Slemrod, Marsha Blumenthal, Charles Christian, *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. Pub. Econ. 455 (2001).

⁶⁹ See, e.g., Blumenthal, Christian & Slemrod, *supra* note 68, at 135.

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Gender: Although some of the study results are mixed, in general the evidence suggests that women are more compliant than men (perhaps because they are more risk averse), respond better to positive appeals (whereas men respond better to negative ones) and respond better to normative appeals.⁷⁰

Age: Older individuals are generally more compliant than younger ones.⁷¹ This could be due to a variety of factors such as older individuals have more social capital (more willing to follow or internalize social norms), have more at risk, and/or have more knowledge of tax.

Education: Findings regarding the correlation of education and compliance have been mixed.⁷² As with other factors, however, mixed findings may be the product of the measurement tools—both how compliance is defined and education measured. Education may correlate with compliance because the internalization of social norms occurs through a process of socialization and education influences that process.⁷³ Education may also correlate with compliance because higher moral reasoning positively correlates and higher moral reasoning can be taught.

Marital status: Findings regarding the effect of marital status are mixed.⁷⁴

Religion: A study of the correlation between tax compliance and religion in more than 30 countries, found a positive correlation for all the main religions but found different correlations with different religions. For example, agreeing with an earlier study, Torgler found that those with a strong Protestant work ethic were more likely to oppose taxation.⁷⁵ The correlation may exist because religion acts as a “supernatural police”⁷⁶ or because it is a proxy for such traits as work ethic and trust.

⁷⁰ E.g., Cullis *et al*, *supra* note 18 (study of UK college students showed male students declared less income when the question was framed as a loss); Janne Chung & Viswanath Umashanker Trivedi, *The Effect of Friendly Persuasion and Gender on Tax Compliance Behavior*, 47 J. BUS. ETHICS 133 (2003); Klarita Gexhani & Arthur Schram, *Tax evasion and Income Source: A Comparative Experimental Study*, 27 J. ECON. PSYCHOL. 27 402 (2006); John Hasseldine & Peggy A. Hite, *Framing, Gender and Tax Compliance* 24 J. ECON. PSYCHOL. 517 521 (2003); Robert W. McGee & Michael Tyler, *Tax Evasion and Ethics: A Demographic Study of 33 Countries*, SSRN abstract #940505 (October 2006)(women more likely to oppose tax evasion than men); Benno Torgler, *Tax Morale and Tax Compliance: A Cross-Culture Comparison*, NATIONAL TAX ASSOC. ANNUAL PROCEEDINGS, 96 ANNUAL CONFERENCE 2003, 63, 71 (females report a higher compliance than males).

⁷¹ See, e.g., McGee & Tyler, *supra* note 70 (consistent with other studies, finds that older people “tend to be more opposed to tax evasion than younger people”); Benno Torgler *The Importance of Faith: Tax Morale and Religiosity*. 61 J. ECON. BEHAV. & ORG. 81 (2006)(using data from the WVS 1995-7 for more than 30 countries at individual level). *But see*, Torgler & Schneider, *supra* note 5 (after age 64 tax compliance decreases).

⁷² Torgler, *supra* note 70 (education has a positive effect on tax compliance.); *but see*, McGee & Tyler, *supra* note 70 (less well educated more opposed to evasion). Kirchner *et al*, *supra* note 6 at 514 (Willingness to cooperate—measured by intent to file correct, timely tax returns—was significantly related to higher self reported tax knowledge. Several studies using education as a proxy for knowledge or measuring objective or subjective knowledge confirm the positive relationship between knowledge and willingness to cooperate or comply [.]”

⁷³ Mazar, & Ariely, *supra* note 30.

⁷⁴ Torgler, *supra* note 72 (singles had lower compliance than married couples and those living together); Andreoni *et al*, *supra* note 2, at 840 (TCMP found greater noncompliance among married couples).

⁷⁵ Benno Torgler, *supra* note 72. *Accord*, Benno Torgler, *To Evade Taxes or Not to Evade: That Is the Question*, 32 J. SOCIO-ECON 283 (2003) (“strong evidence that trust in government, [national] pride, and religiosity have a systematic positive influence on tax morale ... [and] This effect tends to persist even after controlling for age, income, education, gender, marital status, employment status.”)

⁷⁶ Torgler & Schneider, *supra* note 5, at 10.

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Income: The evidence regarding the correlation between income and compliance is mixed.⁷⁷

Using Tax Morale to Increase Compliance

Recently several tax authorities have switched their approach to tax administration from a one-size-fits-all enforcement model to a model that builds on the lessons of tax morale research. Frequently called a self-regulatory or responsive regulation model, this model adopts “carrots,” as well as “sticks” in a manner that matches the tax authority’s response to that of the regulated individuals (taxpayers), saving the sticks for those who are non-compliant. The Australian Tax Office (ATO) has been the leader in responsive regulation in the tax field. This model has now been adopted by other countries (UK, New Zealand, Timor Lese, Indonesia) and the state of Pennsylvania.⁷⁸

Valerie Braithwaite, a leading researcher in the field, describes the responsive regulation, or “tax morale,” model—at least as currently practiced by the ATO—as follows:

[Responsive regulation] refers to the practice of (a) influencing the flow of events (b) through systematic, fairly directed and fully explained disapproval (c) that is respectful of regulates, helpful in filling information gaps and attentive to opposing or resisting arguments, (d) yet firm in administering sanctions (e) that will escalate in intensity in response to the absence of genuine effort on the part of the regulate to meet the required standards. Responsive regulation ... deliberates on shared community goals and understandings, it enforces agreed upon standards, preferably through teaching, persuading and encouraging those who fall short, but it uses punishment when necessary to achieve its regulatory objectives.”⁷⁹

The core of responsive regulation is the dynamic partnership it creates between the tax authority and the taxpayer. It encourages taxpayers to “think about their obligations and accept responsibility for regulating themselves in a manner that is consistent with the law”

⁷⁷ Gerxhani & Schram, *supra* note 70 (compliance increases with higher income); Torgler, *supra* note 70. *But see*, McGee & Tyler, *supra* note 70 (poorer are more opposed to evasion than wealthier, but authors are skeptical of result).

⁷⁸ The Australian Tax Office and Australian researchers have been leaders in responsive regulation from a tax standpoint. See, e.g. Australian Tax Office at <http://www.ato.gov.au/> and Center for Tax System Integrity at <http://ctsi.anu.edu.au/index.html>. For a short summary, see, generally, Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 L. & POL’Y 1 (2007) See also, John Braithwaite, *supra* note 38; Valerie Braithwaite, *Dancing with Authorities*, in *TAKING DEMOCRACY: UNDERSTANDING TAX AVOIDANCE AND EVASION* (Valerie Braithwaite ed 2003); Sagit Leviner, *A New Era of Tax Enforcement: From ‘Big Stick’ to Responsive Regulation* at <http://ssrn.com/abstract=940911> (2006 IRS Research Conference Proceedings); Tony Morris & Michele Lonsdale, *Translating the Compliance Model into Practical Reality, Recent Research in Tax Administration and Compliance*, Proceedings of the 2004 IRS Research Conference (2005) 57-75, available at <http://www.irs.gov/taxstats/index.html> then click on products and publications, and then click on IRS Research bulletins. New Zealand BISEP (Business; Industry; Sociological; Economic; Psychological); Kristina Murphy, *The Role of Trust in Nurturing Compliance: A Study of Accused Tax Avoiders* 8 L. & HUMAN BEHAV. 187 2004)(one of 1st papers to provide empirical evidence to support a regulatory strategy based on trust); Kathleen Carlye & Daniel T. Maxwell, *Understanding Taxpayer Behavior and Assessing Potential IRS Interventions Using Multiagent Dynamic-Network Simulation* available at <http://www.irs.gov/pub/irs-soi/06carley.pdf>.

⁷⁹ V. Braithwaite, *supra* note 78, at 5. See, also, J. Braithwaite, *supra* note 38, at 71 (four “prongs of the ATO Compliance Model are: (a) Understanding taxpayer behaviour; (b) Building community partnerships; (c) Increased flexibility in ATO operations to encourage and support compliance; and (d) More and escalating regulatory options to enforce compliance.”).

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and the tax authority and the tax authority agrees to respond appropriately.⁸⁰ Recently, Feld and Frey have extended the ATO tax morale based model by proposing a “psychological tax contract” which includes positive rewards for compliant taxpayers in a manner that does not undermine internal motivations to comply.⁸¹ Since the psychological contract is premised on the idea of improving tax morale, especially by means of fair procedures and respectful treatment (in other words, procedural justice), it rewards, rather than punishes—taxpayers. The authors broadly conceive “reward” to extend beyond the traditional fiscal exchange of receiving material goods and services for taxes—which, in fact, commoditize taxes—to include “the political procedures that lead to this exchange and the personal relationship between the taxpayers and the tax administrators.”⁸² Although their model applies traditional deterrence when necessary, the authors believe that because “genuinely rewarding taxpayers in an exchange relationship will increase tax compliance, it should thus be considered as the tax authority’s dominant strategy to approach taxpayers in order to enhance their tax compliance, while at the same time being able to resort to punishment if that strategy fails.”⁸³

The responsive regulation model is a positive step towards improving tax compliance by recognizing internally motivated tax morale factors and the role of the tax authority in promoting them. Nevertheless, this model poses several problems. First, a tax authority following the model must navigate a narrow strait between Scylla and Charybdis: being too lenient (or soft) and being too hard—both of which can decrease tax compliance by eroding tax morale. Moreover, a flexible system, necessary for responsive regulation to work, can also decrease tax morale if the necessary discretion creates arbitrary decisions that undermine a sense of procedural fairness. Several commentators have suggested that the way to avoid both problems is through “institutional integrity” which goes beyond “mere procedure” to encompass “the whole matrix of values, purposes and sensibilities that should inform a course of conduct. ...”⁸⁴ Authorities must not only deal fairly with taxpayers but effectively—authorities must conduct themselves in a manner that appears both competent and honest, using procedures that taxpayers view as sensible and efficient.⁸⁵ This will require both training and diligence on the part of the taxing authority.

Another problem of the ATO model is that it does not require the tax authority to know the actual attitudes and motivations of the taxpayer. It assumes that taxpayer attitudes/motivations are reflected in their behavior and it responds according to that behavior.⁸⁶ This assumption, however, is not always true. First, attitudes do not always translate into

⁸⁰ V Braithwaite, *supra* note 78, at 6.

⁸¹ Feld & Frey, *supra* note 42, at 104-05.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ Vivienne Waller, *The Challenge of Institutional Integrity in Responsive Regulation: Field Inspections by the Australian taxation Office*, 29 L. & Pol’y 67, 69 (2007). (citing PHILIP SELZNICK, *THE MORAL COMMONWEALTH: SOCIAL THEORY AND THE PROMISE OF COMMUNITY* 330 (1992)).

⁸⁵ See e.g., *Id.*

⁸⁶ See, e.g. Leviner, *supra* note 78.

behavior. Consequently, it is still important for the taxing authority to understand the attitudes and motivations of its taxpayers in order to transform positive attitudes into positive actions and not crowd out these positive attitudes. Moreover, since different attitudes and motivations may produce the same behavior, the more the tax authority understands about actual attitudes and motivations the more it can respond accurately and positively to taxpayers. That is, if taxpayer B complies because of a social norm that people should comply and taxpayer C complies because of deterrents such as penalties, the same IRS action (*e.g.*, publishing statistics regarding rate of convictions) may affect the two taxpayers' behavior differently. Taxpayer B may decrease her compliance whereas as taxpayer C might increase his compliance.

Mark Burton argues that another problematic aspect of responsive regulation is that tax law—contrary to the model's premise—is not wholly determinate.⁸⁷ Since people disagree as to what the law is, it is difficult to agree on mutual goals, the proper interpretation of laws (or who is the proper interpreter), or to form partnerships to achieve them.

Summary of Tax Morale Literature

Tax morale research, a subset of general research into why people obey laws, has made great strides in understanding tax compliance, but much is still to be learned. It has identified key components of tax morale such as procedural fairness, trust, legitimacy, identification with the group, and reciprocity. It has also identified key mental and affective factors influencing tax morale—such as framing issues—and has begun isolating ways in which external factors can encourage or depress tax morale. Although research has yielded much information, much is still to be learned. Further research will help explain some of the conflicting results in empirical research and provide better guidance for tax agencies to improve compliance.

Although tax morale is a work in progress, enough is known to suggest that tax authorities abandon traditional regulatory models that focus solely on one-size-fits-all enforcement and adopt a “tax morale” model. Several countries, such as Australia, have already done so. Although the tax morale model uses traditional enforcement mechanisms such as fines and audits, it emphasizes taxpayers' internal motivations—social norms, personal values, and cognitive processes. Recognizing that external factors—including actions by the tax authority—can affect norms and values in either positive or negative ways, a tax morale-based tax authority abandons a one-size-fits-all approach to taxpayers and develops more individualized methods to match the differing attitudes and behaviors of different types of taxpayers.

Current tax morale models, such as the ATO's, are a step forward in improving tax compliance, but they do have several limitations. First they can be vague as to exact

⁸⁷ Mark Burton, *Responsive Regulation and the Uncertainty of Tax Law—Time to Reconsider the Commissioner's Model of Cooperative Compliance?*, 5 *JOURNAL OF TAX RESEARCH* 71, 73 (2007).

implementation. Second, the model's flexibility in dealing with taxpayers, which is an advantage, is also a potential disadvantage in that it may lead to inconsistent administrative response. Third, it has the potential of backfiring and lowering tax morale (and compliance) because inconsistent administrative responses may impair the taxpayer's sense of procedural fairness. Similarly, the taxpayer may lose trust in the tax agency if it views the agency's actions to improve morale as manipulative.

A tax morale model can work only as well as the tax agency's understanding of the attitudes and behaviors (always recognizing that the two are not the same) of both compliant and non-compliant taxpayers so that the former may be strengthened and the latter changed. In order to do this, the agency must research tax morale and develop strategies and programs that apply current and future findings to taxpayers and to its own personnel and procedures. The following Part IV recommends the establishment of a structure within the IRS to perform this function as well as provides some specific recommendations based on existing findings.

IV. Recommendations

The application of tax morale research to the formulation of tax laws and their application by the IRS must be an essential part of any successful plan to narrow the tax gap and improve and maintain taxpayer compliance. The findings have broad applicability for Congress and the IRS: They can help shape both laws and procedures; they can apply to both carrots (incentives) and sticks (enforcement/penalties), and they are relevant for all types of taxpayers. These recommendations, however, focus only on the IRS, only on positive incentives, and only on individual taxpayers.

This Report makes three major recommendations and several specific suggestions. The three major recommendations are:

1. The IRS should establish a permanent department or other structure within its organization devoted solely to voluntary compliance issues. Although this structure should address all type of taxpayers, these recommendations cover only individual taxpayers. This Report labels the structure the Behavioral Science Unit (BSU).
2. The IRS should adopt a "tax morale" model of compliance that incorporates internal taxpayer motivations and emphasizes a more individualized carrot and stick approach than traditional tax collection models.
3. The IRS should implement long and short term educational and media programs to encourage voluntary compliance that incorporate the findings of behavioral research.

The first three sections of this Part describe the major recommendations generally. The final section suggests several more particular topics to be explored or implemented by the Behavioral Science Unit (BSU). Although some recommendations can be broadly phrased

and have widespread effects, there can be no one-size-fits-all recommendation that will improve all taxpayer compliance. Since the amounts, types, and causes of individual noncompliance are so varied, some recommendations can only target certain types of noncompliance.

First Major Recommendation: Establish a Behavioral Science Unit [BSU] within the IRS

Scope

Although the BSU derives its name from a similarly named unit within Her Majesty's Revenue and Custom (HMRC), this Report envisions a broader scope than that currently engaged in by the British unit. Ideally, the BSU should encompass many functions, such as evaluating third party research, conducting its own independent research, advising other parts of the IRS and helping implement research findings. Whatever its scope, for maximum effectiveness, the BSU should be a permanent feature of the IRS with resources and personnel dedicated to compliance issues. Compliance involves many disciplines and many types of tasks such as research, developing IRS procedures and strategies, educating the public, and educating and training IRS officials. Although behavioral research can enhance both the positive (carrot) and negative (stick) tools which the IRS needs for compliance, these recommendations focus on the positive aspects. The next section sketches a description of the types of personnel the BSU should hire and the functions it should perform.

Personnel

Ideally, a full-time director should head a full-time staff composed of persons with expertise in a variety of fields such as economics (especially behavioral economics), psychology, sociology, education, marketing, and even moral philosophy. The multi-disciplinary approach serves a dual function. First, it increases the breadth, depth, and sophistication of expertise since different fields have different strengths and perspectives. The multi-disciplinary approach, however, also increases the chance that other IRS personnel will accept the findings and assistance of the BSU since different people value different disciplines.⁸⁸

The BSU should also hire outside consultants, when necessary, to perform a variety of functions such as research or designing educational and marketing campaigns. Many projects will require collaboration not just with IRS officials outside the BSU but with people in other disciplines as well as other government, private, and non-profit organizations, and the public generally.

Given the diversity of tasks, the staff as a whole should have theoretical, empirical, and practical capabilities. Some people must be able to design or evaluate empirical studies; others must be able to design (or help design in conjunction with outside experts)

⁸⁸ Author interview with HMRC personnel, London, May 23, 2007.

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educational and training materials; still others must have the interpersonal skills to interface with people within the IRS and with the general public as well as other agencies.

Functions

The BSU ideally should perform many functions including research, analysis, advising the IRS, education, and training. Some of this work may be initiated by the BSU itself while other projects may be contracted for by other portions of the IRS in the furtherance of some strategy or procedure it is developing. The following sections generally describe some of these functions. The final section of this Part suggests some more particular areas of inquiry, but many more exist or will develop as research continues.

Research and Analysis

Knowledge in motivational and behavioral aspects of taxpayer compliance draws from a variety of fields including law, psychology, political science, and economics. Some of this research is specific to tax; other research deals with laws that have similar compliance issues, such as recycling, while some concerns compliance generally such as research regarding the role of shaming. Still other research is not directly related to law but is relevant to tax compliance because it involves cognitive behavior generally, such as education (how people learn), political science (what makes people vote for certain candidates/policies), moral philosophy/reasoning (stages of moral reasoning), and marketing/advertising (issues of vital concern to tax: framing, trust, and loyalty).

The BSU should perform original research, evaluate research of others, and also apply that research, creating practical solutions to compliance problems. Its personnel should engage in a variety of research tasks including reading existing theoretical and empirical studies; consulting with tax authorities in other developed countries, and conducting empirical studies. The latter, which might be done in conjunction with outside consultants, should draw on both the vast amount of data the IRS possesses as well as using knowledge garnered from existing literature. It should help other IRS units evaluate their problems, suggest appropriate research, and help translate that research.

Empirical studies should extend beyond laboratory and survey experiments to include developing new methods to increasing compliance. This task involves designing and executing field studies with actual taxpayers, such as those done in Minnesota, or in Australia.⁸⁹ As the BSU gains more experience and knowledge, more of its efforts should be devoted to implementing its findings; designing and conducting these experimental studies would be a first step towards doing so. These trial experiments should cover all aspects of compliance such as designing forms, procedures for personnel, and educational material.

⁸⁹ See, Michael Wenzel, *A Letter from the Tax Office: Compliance Effects of Informational and Interpersonal Justice*, 19 SOCIAL JUSTICE RESEARCH 345 (2006).

Educational/Training Component

Although tax morale has strong affective components, education can still play a major role in maintaining and improving compliance. Knowledge increases taxpayers' sense of control of their tax situations and also increases the chances of filing accurate and timely returns. Consequently, knowledge can decrease feelings of frustration as well as decrease the actual amount of time a taxpayer must spend on taxes. Education is also a powerful tool for increasing taxpayer morale by strengthening feelings of identity, reciprocity, fairness, procedural justice. Furthermore, education can ensure that IRS personnel act—and are perceived as acting—in a fair manner which is essential for tax morale.

In light of education's importance, the BSU must be involved in both internal and external education to meet the varying needs of taxpayers and personnel. Internal education includes revising IRS procedures and forms; training IRS personnel in behaviors that increase compliance, and developing recommendations for Congress. External education spans a vast spectrum of long term and short term educational programs for all ages of people, from children to the elderly, and all types of taxpayers—from unsophisticated individuals to tax preparers.

The IRS needs a range of educational programs to meet the various needs of taxpayers. Different portions of the population not only have different learning styles, but different tax issues, different psychological motivations, and differing social norms. The BSU should develop some of these programs in cooperation with other institutions. For example, it could partner with university departments such as an education department to design curriculum or it could work with law school organizations such as Georgetown's Street Law program. It could also work with professional accounting and legal organizations such as the Tax or Legal Education Sections of the American Bar Association (ABA).

The IRS already engages in some educational programs and literature. For example, it has published a series of "fact sheets" on topics that affect many taxpayers such as travel/entertainment expenses, the EITC, Tax Tips (such as for the treatment of a child's investment income) as well as radio public service announcements (in English and Spanish as well as country-western format).⁹⁰ Education and outreach programs developed in connection with outside experts could improve the focus and effectiveness of these programs.

Second Major Recommendation: Adopt a "Tax Morale" Model

The IRS should adopt a model that incorporates the findings of behavioral compliance research. Unlike the traditional compliance model, focused on enforcement via penalties, a tax morale model, acknowledging internal taxpayer motivation for compliance, emphasizes a more individualized carrot and stick approach. It recognizes that different taxpayers have different taxpaying attitudes and behaviors; that these attitudes and behaviors change over

⁹⁰ See, e.g., FS_2007-10, January 2007 (updated 2/14/07) Deducting Travel, Entertainment and Gift Expenses at www.irs.gov, Newsroom section for the PSAs and tax tips.

time, and that these attitudes and behaviors are affected by interactions with others, including the tax authority. The model seeks to make compliance easier for taxpayers, but strictly enforce penalties when they fail to comply. In devising its model the IRS should not only evaluate the tax morale literature but consult other tax authorities that have instituted such models (such as Australia and New Zealand).

Third Major Recommendation: Establish Educational and Media Programs

Rationale

Knowledge of mere facts does not necessarily change people's attitudes nor increase their compliance with norms or laws since people are often guided by heuristics, cognitive processes and other short cuts or rules of thumbs rather than rational thought. At first glance, then, it might seem that there is little role for education. This is not the case. People can be trained to think logically. Furthermore, the more they know about a subject, the easier it is for them to think and act based on logic and information and not on unexamined biases, frames, and other unconscious cognitive processes. More importantly, information can influence these very processes and both social and personal norms.

Education enhances compliance in a variety of ways. Most obviously, people make fewer unintentional mistakes the more they know. They also will be less frustrated when trying to comply with the tax laws. Knowledge gained from education should also decrease a taxpayer's time spent on taxes which should also decrease frustration and increase compliance. Research shows that education also enhances compliance in more complicated ways that increase tax morale. Various techniques can encourage tax morale in the short term, but as the literature review has shown, many of the attitudes and personal norms that are components of tax morale begin to form early and accumulate over time. Consequently, efforts to improve tax morale must be ongoing and begin in a person's formative years—childhood.

One education program will not suit all taxpayers. People have different learning styles—some learn better visually; others aurally, and so forth. Different audiences also require different content. In some contexts this is obvious. A program for elementary school children must differ from one for adults, for example. A program for native speakers will be different than one for taxpayers whose primary language is not English.⁹¹ A program for tax preparers should be different than one for individual taxpayers. Taxpayers differ on the type of tax information they need, as well as their level of sophistication. There are other differences among audiences, however, that are more subtle, but often not addressed, such as norms of subcultures. Gender, too, must be taken into account since studies indicate wide differences between genders in risk aversion, moral reasoning, and even responses to

⁹¹ Christine C. Bauman, David Luna & Laura A. Peracchio, *Improving Tax Compliance of Bilingual Taxpayers with Effective Consumer Communication*, 2005 IRS RESEARCH CONFERENCE 247 (2006)(pictures increased accuracy of bilingual taxpayers).

compliance appeals. Women, for example, respond more to “friendly” persuasive arguments whereas men respond slightly negatively.⁹²

The IRS must also conduct internal education and training because the literature indicates that taxpayers’ perceptions of the tax authority’s procedural fairness is an essential component of tax morale. Consequently, training all IRS personnel—especially those dealing directly with the taxpaying public—to be as neutral, objective, polite, respectful, and fair as possible is just as important as training them in the technical aspects of the tax law. Moreover, the adoption of any new procedures, especially those that move from the traditional model with which many IRS personnel are familiar (and so comfortable) to a more self-regulatory model (with which they are less familiar) must be accompanied by intensive personnel training. This training should include not just the specifics of new procedures, but should ensure that personnel understand the reasons for the switch to these procedures and that they commit to them.

Although internal education is vital, the remainder of this section focuses on external education of taxpayers—both current and future ones.

Goals of Education

The goals of educational programs should be both general and specific. They must provide specific knowledge about the role of tax and how the tax system works. Additionally, they should encourage attitudes and behaviors that compliance research indicates are associated with higher tax morale and compliance, such as a sense of civic duty, trust, altruism, integrity.

Providing factual knowledge is fundamental to any educational program because Americans generally are quite ignorant about taxation. For example, a 2003 survey by the Kaiser Foundation and Harvard Kennedy School for National Public Radio (NPR) on taxes revealed that 34 percent of respondents did not know whether they paid more Social Security/Medicare taxes or income taxes, and only 50 percent of respondents knew that there had been a tax cut in the past two years.⁹³ Consequently, there is a great opportunity for the IRS, public agencies, schools, and non-profits to provide information about the tax system generally, changes in legislation, as well as specific information about certain tax provisions. This information could be provided at different levels of complexity to different audiences ranging from elementary school children to tax preparers.

People cannot think rationally about fiscal policy without linking taxation and expenditures. Similarly, they cannot think rationally about taxation without talking about its benefits as well as its burdens. Currently, both politicians and the media emphasize the burdens. Politicians, for example, often claim that the tax burden has increased or is too

⁹² See Chung & Trivedi, *supra* note 70.

⁹³ Questions 63 and 11 available at http://www.npr.org/news/specials/polls/taxes2003/20030415_taxes_survey.pdf; 33 percent said there had not been and 17percent didn’t know.

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heavy and, therefore, Congress needs to cut taxes. They rarely mention, however, the benefits of taxation, or the fact that tax burdens are relatively low both historically and relative to other nations. They often talk about taxes generally without differentiating between federal taxes and state/local taxes.

The news media treat taxation similarly. They usually fail to differentiate between marginal and effective rates, for example. As another example, NBC Nightly News has a segment called The Fleecing of America that highlights programs that waste taxpayer money; it does not have a segment mentioning programs that benefit the taxpaying public. When a government agency, for example, tracks down the cause of an *e coli* outbreak, the media does not praise the use of tax dollars, but it will criticize the agency for taking so long to do so—even if the agency’s budget has been cut. In short, media and the politicians focus on the negative aspects of taxation for the individual and society, but usually fail to mention the positive good they create.

Although studies show that there is a connection between the perception of public goods and tax compliance,⁹⁴ there are grave dangers in linking taxation to specific expenditures. First, such a linkage may create a strict benefits or fiscal exchange view of tax. A narrow fiscal exchange view may lead some taxpayers to perceive exchange inequality which, in turn, causes them to see taxation as unfair. Once they see the tax itself as unfair, they may be less willing to pay. Second, people frequently do not agree on whether a particular expenditure is worthwhile. Consequently, linking a certain amount of tax to a certain good or service may decrease a taxpayer’s willingness to pay the tax if he or she does not value that particular program.

There are ways to minimize this danger. General discussions about the concept of “public goods” might, for example, make citizens more amenable to taxation. Other possible solutions are listed below. Some of them relate specifically to tax; others encompass the role of government, generally. Most of them require sustained educational campaigns because components of tax morale, such as trust, take a long time to build—even though they may deteriorate quickly. Since many tax morale components involve schemas and affective qualities that develop early in life, some educational programs should be directed at youth—long before they become taxpayers. Various school curricula in social studies or economics, for example, are ideal places for children to learn about the role of taxes in society and to become tax literate.

People acknowledge that voting and jury service are civic responsibilities (although often honored in the breach), but rarely think of taxation as one. Education campaigns could help change this view. Once paying tax is viewed in this light, people could be encouraged to take pride in doing so, just as they take pride in voting or helping their place of

⁹⁴ See, e.g., James Alm, Betty R. Jackson & Michael McKee, *Fiscal Exchange, Collective Decision Institutions and Tax Compliance*, 22 J. ECON. BEHAV. & ORG. 285 (1993).

employment reach United Way goals. For example, taking a cue from get-out-the-vote campaigns, they could also have stickers saying “I paid my taxes today.”

The literature indicates that certain characteristics correlate with higher tax compliance, such as trust, reciprocity, a sense of national identity and altruism. The IRS could incorporate aspects of this research into its educational campaigns.

Research indicates that high moral reasoning correlates with higher tax compliance and that education is an important factor in increasing moral reasoning. These connections suggest that education in ethics and moral reasoning could improve compliance. At least one study suggests this: “[E]ducation may improve tax compliance. Further, the results also highlight the importance of encouraging and maintaining a positive attitude towards governments among the general population to achieve a tax compliant population. Thus, policies that encourage/emphasize education and ethical behavior may be an effective method of increasing the level of taxpayers’ compliance.”⁹⁵

Examples of Specific Educational Programs

Design Curriculum for Schools

States and school districts prescribe curricular guidance for grades K-12 in various subjects including civics, social studies, and economics. Although taxes are integral to all these topics, taxation usually plays little or no role in the curriculum. The IRS, in conjunction with educational and curricular experts, could devise curriculum appropriate for all ages. There are various less traditional ways to present this information. For example, many law schools have a Street Law Program in which law students teach high school students about various aspects of the law. Media popular with the young—such as videos and the internet—could also be used. In 1998, for example, the Federal Reserve Bank of New York published a comic book describing how foreign trade works.⁹⁶

“Deliberation Day” Discussions

In their 2004 book “Deliberation Day,” Bruce Ackerman and James S. Fishkin proposed town hall type meetings before presidential elections day to discuss the candidates and issues. Similar type of meetings could occur at the start of tax season, in town hall meetings, and/or on television, radio and the Internet.

Annual Income Statement

Every year the Social Security Administration provides a short explanation of how social security works and a summary of a taxpayer’s past contributions and potential benefits. A similar pamphlet distributed annually by the IRS might help taxpayers both understand the system better and feel more ownership.⁹⁷

⁹⁵ Trivedi, Shehata, & Lynn, *supra* note 22 at 193.

⁹⁶ CEDRIC FAN, *THE STORY OF FOREIGN TRADE AND EXCHANGE* (1998).

⁹⁷ Marjorie E. Kornhauser, *Doing the Full Monty: Will Publicizing of Tax Information Increase Compliance?*, 18 CAN. J. L. & JURIS. 95 (2005).

Suggestions Regarding Media Campaigns

The IRS should conduct an extensive media campaign regarding taxes in order to reach the widest number of the public. Some of these campaigns should focus generally on taxes while others could concentrate on specific tax issues. The EITC outreach program is a good start for a model, but the suggested campaign must go beyond that in terms of media outlets, content, and purpose. The campaign's goal should be to encourage values and norms that enhance tax compliance not simply to convey tax information. The campaign should seek to develop those values and norms, discussed in the literature review, that are connected with high compliance including trust in the government and a sense of civic duty to pay taxes. It should also stress the competency of the IRS. Many taxpayers may not question the honesty of IRS officials, but they may doubt the efficiency and/or ability of IRS personnel.

The danger of a media campaign, like the danger of an education campaign, is that it could backfire. It might cause taxpayers to feel manipulated, which would increase cynicism and potentially more non-compliance. In order to prevent (or minimize) these negative consequences the IRS must move cautiously and with the aid of outside experts.⁹⁸

Successful marketing utilizes many of the same principles that enhance tax morale, such as reciprocity, norms, and trust in authority.⁹⁹ Marketing campaigns also use many tactics that would be helpful in campaigns to improve tax compliance, such as formulating suggestions in the positive not negative. The following suggestions indicate some of the possibilities of a marketing campaign.

Public Service Ads, Using Marketing Principles

Public service campaigns should target specific markets so that different types of taxpayers receive different ads. Ads would vary in both form and content. Content could be varied to target the characteristics of different demographic taxpayers, as shown in the research. The form should also match the target audience in language and media use. Appropriate language is not just limited to whether the campaign should be in English or another language, such as Spanish. Even within a group that speaks the same language, word style and slogans appropriate for one sub-population—such as the elderly—will not be the most effective usage for a group in their early 20s, for example. Similarly, the most effective media for one group (*e.g.* newspapers) will not be the most effective media for the internet-savvy younger generation.

Advertisements should harness the power of particular people to influence others. Politicians, advertisers and even charities know that a celebrity spokesman can influence

⁹⁸ See, *e.g.* Tax Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance (1998) Chapter 16 Relationship with Taxpayers, at www.taxpolicy.ird.govt.nz/publications/files/html/coe/chapter16.htm paragraphs 16.33-16.36.

⁹⁹ See, *e.g.*, Cialdini, *supra* note 8 at 205-220 and Cialdini, *supra* note 56.

others to support their project (or buy their product). The IRS should use similarly influential people to support paying taxes.¹⁰⁰

Use the Internet and Videos

Tax campaigns should employ the Internet's well-known ability to reach large numbers of people. For example, in 2007 Turbo Tax made unique use of the Internet and fascination with YouTube during the 2006 filing season by sponsoring a rap video contest, with an award of \$25,000 for the best tax video. (Interestingly, no mention is made on the webpage that the prize is taxable.) The contest was introduced in a rap video called Turbo Tax Mojo by Vanilla Ice,¹⁰¹ urging people to pay their taxes (on time!) and of course use Turbo Tax to do so. Less than one week after the contest started (February 8), 37 videos were posted.

Use the Media (and Media Talent) Creatively

In World War II, the government used Donald Duck to persuade Americans to pay their income taxes. The IRS could similarly encourage the development of tax themes in TV shows or other mass media—either as a small segment or even the theme of an episode, as occurred a few years ago on “The Simpsons.” People acquire a great deal of information from entertainment on television, not just from news programs. They also act upon it. For example, after viewing episodes about breast cancer on “ER,” one study showed that viewers were more likely to schedule a breast screening exam than non-viewers.¹⁰² In 1989 Robert Cialdini suggested a TV special, which he labeled the National Tax Test, airing one month before April 15th after the earlier television show, the Great American Values Test.¹⁰³ Today, with the reality and game shows so popular, his idea could be expanded into a series of episodes modeled either as a reality show or a game show.

Additional Specific Suggestions

There are many promising areas of research—some basic research and others more narrow implementation of theoretical findings. The following focus on the more practical aspects and are in no way meant to be comprehensive.

Demographic Factors

The IRS and theoretical research have already begun identifying various segments of the taxpaying population that have different characteristics. The BSU should continue this work and then devise strategies that build on this new knowledge.

¹⁰⁰ See, e.g., MALCOLM GLADWELL, *THE TIPPING POINT: HOW LITTLE THINGS CAN MAKE A BIG DIFFERENCE* (2000) (discussing the “law of the few” in which the messenger is as important as the message).

¹⁰¹ Available at <http://www.youtube.com/watch?v=eMudXTz4NuQ>. (viewed 13 February 2007). For the winning tax rap, see www.youtube.com/contest/thetaxrap. Some of the videos submitted can be viewed at <http://www.youtube.com/watch?v=UHx7P6zfOFs> http://www.youtube.com/watch?v=Y2hZS_ZRZHY (accessed 16 October 2007).

¹⁰² See, e.g. Stephen Smith, *The doctor is on*. BOSTON GLOBE, 12 December 2006 at C1.

¹⁰³ Cialdini, *supra* note 8, at 209.

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IRS Procedures to Improve Procedural Justice

The literature contains many studies concerning the importance of procedural justice in tax morale. Some experimental research has already been conducted in the field of communications with taxpayers, such as the effect of various form letters on compliance. The BSU should continue to explore and experiment with various procedures and strategies that would improve taxpayers' sense of fairness. These range from improving IRS contact with taxpayers (whether by letter, in-person or phone contact) to training personnel to treat taxpayers with more respect and politeness—factors that influence tax morale. The following suggestions are illustrative of a few of the many issues the BSU might investigate.

Reconsider Nomenclature: Customer v. Taxpayer

The literature on behavioral compliance suggests that the IRS should reevaluate the term it uses for a person who pays taxes. In recent years, many collection agencies, such as the IRS have emphasized the term “customer” instead of “taxpayer.” The two terms may provide different signals and therefore influence taxpayers and IRS officials differently.

The term *taxpayer* may have both positive and negative effects on IRS personnel.¹⁰⁴ On one hand, using the term *customer* may improve how personnel treat taxpayers because it lessens any bureaucratic and authoritarian impulses. On the other hand, calling taxpayers customers has negative effects. First, given the often poor state of customer service, IRS officials may simply treat taxpaying *customers* with the same poor service they may have received as customers in stores. Furthermore, “customer” transforms a taxpayer into an isolated purchaser and not a citizen performing a civic obligation. This devalues the civic duty aspects of paying taxes and the greater identification with the nation as a whole which, research has shown, makes a taxpayer more likely to comply.

By turning paying taxes into a commodity like buying pizza, the term *customer* may decrease tax morale by “crowding out” internally motivated compliance behavior that derives from intrinsic personal norms, such as integrity and patriotism. If the taxpayer is merely a customer, then paying taxes is no different than paying off a car loan, except that the IRS may be viewed more hostilely than other creditors because it carries a bigger stick. Moreover, if a tax debt is no different from a car debt, the individual will see these greater enforcement powers as unfair—at the least—or even evil and violating the individual's constitutional rights—and therefore un-American.

The term *taxpayer*, on the other hand, emphasizes the civic responsibility of taxpaying and confers dignity and respect on the taxpayer. Being treated in this manner can heighten a taxpayer's sense of fairness, according to research, and therefore increase tax morale and tax compliance. A taxpayer is different from a customer buying a pizza. The term taxpayer distinguishes the two transactions and adds both seriousness and a dignity to the individual and the transaction.

¹⁰⁴ See, e.g., *New Zealand's Tax Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance*, *supra*, note 98.

Compensatory Measures, Including Apologies

Taxpayers can develop especially negative feelings about the IRS and taxes when there is a dispute about the proper amount of tax owed, or even if there is just an unpleasant interaction with IRS personnel. Marketing studies concerning complaint procedures provide insight regarding efforts that help reduce negative attitudes towards firms and improve customer loyalty. Although the IRS, being a monopoly with which all taxpayers must deal, need not worry about its customers abandoning it for a competitor, the IRS must still worry about taxpayer satisfaction. Discontented taxpayers may minimize what they owe, pay their bills only after lengthy (and expensive) IRS procedures, and some taxpayers may fail to pay any taxes at all. Dissatisfaction with IRS procedures, in short, decreases tax morale which adversely affects compliance.

The IRS can apply knowledge and techniques that firms have developed to increase to customer satisfaction and brand loyalty when confronted with complaints. Positive procedures identified through research and experience include (1) compensation measures (*e.g.* refunds, replacements, repairs), (2) responsive employee behavior (especially “empathy, politeness, and an effort to listen”), and (3) prompt responses.¹⁰⁵ The last two factors are easily applicable in the tax context, but even the first—compensation measures—may be applicable in the tax situation, especially if compensation is broadly construed to include emotional compensation such as apologies, or extra help, or faster service next time.

Apologies can range from simply acknowledging a taxpayer’s inconvenience or regretting the inconvenience to an admission of negligence or even wrongdoing. Both the IRS and the taxpayer will react differently to different types of apologies. This is an area worth investigating.

Shaming/Publicity

Some states now publicize the names of delinquent taxpayers as a “shaming” device. Although the literature indicates that shaming may have mixed results, the BSU should both investigate the results states have produced and research the implications and effectiveness of shaming more generally.

Rewards

Although economic incentives can backfire and decrease compliance by “crowding out” internally motivated behavior, rewards—broadly construed—may still have a role to play, if carefully constructed. Monetary rewards, such as rebates of a percentage of the tax, can be counterproductive. They may decrease (crowd out) internal motivations to comply because the taxpayer may consider them discounts, like rebates in a commercial setting, and thus ones to which he or she is entitled. On the other hand, a taxpayer may view a non-monetary reward which is not based on the amount of tax paid more favorably and see it simply as an acknowledgement of good behavior. This type of reward, research suggests, may not

¹⁰⁵ Estalami, *supra* note 46, at 289.

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decrease morale. Some compliance experts have suggested various types of these rewards that would indicate appreciation of good citizenship without commoditizing taxpaying and decreasing tax morale, such as reduced public transportation fares, or free admission to museums and cultural events.¹⁰⁶

There are other possible rewards of this nature. Taxpayers who have paid the correct amount of taxes in a timely fashion for a stated amount of time, for example, might be given faster access to assistance such as special phone lines that have a shorter wait. This approach is less drastic, and perhaps more acceptable, than the recent suggestion by Professor Joshua Rosenberg, University of San Francisco School of Law, of rewarding taxpayers who provide extended reporting with lower tax rates.¹⁰⁷

It is possible to integrate rewards with sticks. HMRC, for example, is toying with the idea of requiring individuals to show a certificate of tax compliance to renew certain licenses like taxi licenses.¹⁰⁸ Certainly, all federal employees and independent contractors could be required to show that they are current with all taxes, and perhaps, have not been delinquent for a specified amount of time.

Tax Preparer Education and/or Registration

Many professions require continuing legal education. California is now requiring preparers to register with the California Tax Education Council, which requires continuing education and maintains a code of conduct.¹⁰⁹ Although many preparers—such as accountants—are members of a profession that already requires Continuing Legal Education (CLE), that education may not address tax compliance issues specifically or in a manner that focuses appropriately on the topic. CLE specifically targeting preparers might better improve compliance. CLE has many critics, including those who claim it is ineffective; people attend, for example, but read the newspaper instead of listening. Certain types of CLE address these deficiencies more than others. For example, those requiring the practitioner to pass a test should improve knowledge better than those that merely require attendance.

V. Conclusion

Behavioral research about compliance generally and tax compliance specifically holds much promise for improving voluntary tax compliance. Since it is a rapidly growing and complex field, the IRS can best take advantage of its findings by dedicating—on an ongoing basis—time, money and personnel to it. This Report contains three major recommendations: 1) the IRS establish a Behavioral Research Unit which would keep abreast of current developments, conduct independent research, supervise contract research, and help

¹⁰⁶ Feld & Frey *supra* note 42, at 111.

¹⁰⁷ Tax Gap Stakeholders Debate Tax Gap Elements, Differ on Methods to Improve Compliance, BNA Daily Tax Report, June 25, 2007 at G-8.

¹⁰⁸ Author Interviews with Simon Norris (head of Review of HMRC Powers Team in HMRC Business unit (Central Policy)), Gordon Smith, Deputy Director of Debt Management & Banking and Georgina Halligan, Process & Strategy of Debt Management & Banking. (London: May 23, 2007).

¹⁰⁹ Speakers Support Multifaceted Approach, Incremental Steps to Combat the Tax Gap, BNA Daily Tax Report, June 25, 2007 at G-10.

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implement findings throughout the IRS; 2) the IRS adopt a tax morale model of tax compliance that recognizes that taxpayers have varying attitudes and behaviors regarding tax and matches IRS behavior with that of taxpayers, 3) the IRS engage in educational efforts aimed at all segments of the population to improve taxpayer knowledge, attitudes, and behaviors. The Report also suggests, as examples, several areas that merit further exploration.

Applying the findings of behavioral research is essential to maintaining and improving compliance, but it also carries a grave danger: the possibility that the public—or portions of it—will interpret the use as manipulation. In the commercial setting, people are cynical about manipulation, but accept it as part of the marketplace. They are less accepting in the public sphere and cynicism here can backfire and cause a decrease in compliance. In order to forestall such cynicism, the IRS must both act and be seen as acting sincerely. Research indicates that strict adherence to procedural justice and to respectful modes of communication will help. The BSU, however, must continue to research this aspect, too.

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